INTRODUCTION TO

ISLAMIC MICROFINANCE

Mohammed Obaidullah

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FOREWORD

Our world is full of contradictions. We find here abject poverty, hunger and need side by side with the unabashed luxury, abundance, plenty and fancy. It is probably for the first time in the history of humanity, thanks to modern science and technology, that Man has means to conquer poverty, hunger and need. But, the inquisitive nature of man, his lust and greed continue unabated and till date remain unconquered. Hence, the contradictions, wealth of an Arab prince has been described thus: He is the proud owner of a car studded with diamonds worth several million dollars, a ship worth 500 million dollars, a personal jet aircraft and a palace with more than 300 rooms. On the other hand, billions of human beings on the same earth are deprived of clean and healthy drinking water. They live without any access to any decent sewage facility worthy of human beings. Millions of people still go to sleep on an empty stomach without a square meal. All this is there, while it has been estimated that it would require only US $21 billion to provide micro finance facilities to world's poorest 100 million families. Only if seven of world's richest families got together, they could wipe out the curse of poverty from the face of this earth. However, the world is not run only by Charities. So, the seven richest families did not get together and the poverty is where it was.

Micro financing is a way out of this impasse. Historically speaking, it is also a product of altruistic motives, mostly by the non-governmental organizations, popularly known as NGOs. The emergence of micro financing is a testimony to the fact that all is not well with our world and there are a number of known and unknown lacunas with prevailing systems of commercial banking, financing, and resource allocation. Amongst the known lacunas there are problems of adverse selection and moral hazards which are regularly covered in the text books.

The present system of commercial banking is based on minimization of risks and maximization of profits. The sectors which are served well by it are trade, commerce and industry where risks could be measured rather easily and where quick returns are possible. It leaves out the sectors like agriculture and small scale industries as well as heavy and large scale industry where very large investments are required. This problem was solved by the creation of specialized financing institutions. The specialized financing institutions cater to the needs of specialized sectors such as agriculture, small and medium industry and even heavy industry.

However, the entire banking and financial system comprising of private commercial banks and semi private-semi public specialized banks and financial institution leave a large chunk of population untouched by their activities. These are the poor, poorest of the poor and marginalized people who do not enter into the market at all. Some non-governmental noticed that there are two stumbling blocks which hinder the access of poor people to the banking and financial system:

- High cost of financing
- High cost of processing
- System of collaterals.

The urban concentration of modern commercial banks is another stumbling block. It is well known, hence needless to point out that modern commercial banking developed hand to hand with industrialization and urbanization. Hence, most banks are found in urban areas. The micro financing institutions, on the other hand, aspire to take financial services to their clients in the rural areas, where they come from. They also wish to keep the cost of processing as low as possible, in many cases, eliminating the hugely costly paper work altogether. The system of collateral has resulted into a situation where banking and financial system functions for the benefit of rich only. There is credit for you if you can produce collateral only. Be it a house, land, jewelry, factory, raw material, semi finished products, or just claims to some ownership. No collaterals and No credit. It is that simple. That means that the banking and financial system makes a circuit of wealth amongst the rich only. Since poor people are known to have to access to any kind of assets, they cannot get credit from the banks with the result that they are left out.

Another important development in international banking is the emergence of Islamic banking, also known as interest free banking in some quarters. Since its inception, more than a quarter century ago, Islamic banking has manifested itself in various regions and in various forms. There are Islamic banks in the corporate sector, in the unorganized sector, in the government sector etc. Many standard commercial banks have started operating what is called “Islamic Windows” [Misr Bank in Egypt and National Commercial Bank in Saudi Arabia] through which “Islamic products” are offered through normal banking channels and the consumers have a choice to make. Similar choice is given to customers by some Multinational Banks by especially established and wholly owned subsidiaries [HSBC Amanah by HSBC and Citi Islamic Investment Bank, Bahrain by the Citibank.] However, much activity is claimed by the Islamic Banks in the corporate sector which are active in the international market.

It may be sad but it is a fact that Islamic banking is emerging as a second line of defense for the International Commercial Banking "offering *Halal* products" and bringing in new untapped markets to the "fold". Islamic banking, like its conventional counterpart, is fast becoming "banking of the rich, by the rich, for the rich."

But what about the egalitarian social and economic objectives of Islam? What about claims of superiority of Islamic model over capitalistic model on grounds of equity and Justice. What about the *Maqasid al Shariah*? Are these forgotten in the pomp and show of the world of high finance?

It is in this background that merit of this monograph on Micro Finance in Islamic Perspective must be judged. Its author, Dr. M. Obaidullah has done a yeoman's service to draw our attention to cherished role that Islam can play in elimination of poverty in Muslim societies. He has freshly and rightly interpreted the age old Islamic institutions of *Zakah*, *Awqaf* and *Qard Hasan*. He classifies the Islamic instruments of poverty alleviation into two categories:

1. Charity based and Not for Market
2. Profit based.

Dr. Obaidullah considers that *Zakah*, *Awqaf* and *Qard Hasan* as those instruments which must be geared first to fulfill consumption needs. In the next stage of empowerment program, emphasis may be shifted to profit based instruments where micro enterprises may be encouraged.

These ideas need not only academic debate and testing. Their real test would be in the field where the usefulness or otherwise could be proven. I hope that some Muslim entrepreneurs, social activists, and micro finance institutions shall pick up ideas contained in this book and show their usefulness. Dr. M. Obaidullah is an academician in the first place. He has a written a nice and presentable monograph in a lucid style and with logical neatness. My Congratulations to him on this accomplishment.

Ausaf Ahmad
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September 20, 2008

PREFACE

This monograph explains the building blocks of a microfinance program targeted at Islamic societies. Islamic societies are characterized by high and rising levels of poverty and financial exclusion. Financial exclusion is aggravated by failure on the part of conventional microfinance programs to give due importance to the religious sensitivities of Muslims. For poverty alleviation efforts to succeed in these societies, there is need for an appropriate model that is rooted in Islam and conforms to beliefs, cultures of the Muslim clients.

The monograph argues that there are no fundamental contradictions in the global microfinance best practices and the Islamic approach to poverty alleviation. It seeks to present the Islamic approach as a composite and compassionate one that is rooted in charity, but permits wealth creation and for-profit enterprise. Spanning over four chapters, it focuses on the mechanisms, models, tools and instruments of the Islamic approach as prescribed by the glorious Shariah. It is strongly recommended that the monograph should be supplemented by an accompanying text *Introduction to Islamic Finance* published by IBF Net, which provides a more elaborate and systematic discussion of the principles of Islamic finance. To avoid duplication, these are either omitted in the present text or briefly touched upon wherever deemed desirable in the interest of maintaining continued interest of the reader.

A project of this nature would not have been complete without the support of my family members – wife Shahana and kids Alim, Imad, Zabi and Adib. I dedicate this book to their unquestioning support and sacrifice. I am also thankful to my dear colleagues at IBF Net – Brothers Shafeeq and Azad – and to Dr Ausaf Amad, President, IBF Net in particular for undertaking a thorough review of the manuscript and making many useful suggestions for improvements that I have tried to incorporate in the text.

Mohammed Obaidullah
Jeddah, Saudi Arabia
September 21, 2008

Chapter 1

MICROFINANCE AND POVERTY ALLEVIATION

Poverty is the biggest moral challenge of this century. More than three billion human beings in this world live in abject poverty. Muslim societies fare far worse than the rest of the world in the matter of addressing the problem of poverty. The Islamic world is enormous with over 1.2 billion people, stretching from Senegal to the Philippines – comprising six regions: North Africa, Sub-Saharan Africa, the Middle East, Central Asia, South Asia, and Southeast Asia. Except for a handful of countries in Southeast Asia and the Middle East, there are high and rising poverty levels in both urban and rural parts of most Muslim countries. Poverty levels have also been associated with high inequality alongside low productivity. In Indonesia alone with world's largest Muslim population, over half of the national population - about 129 million people are poor or vulnerable to poverty with incomes less than merely US$2 a day. Bangladesh and Pakistan account for 122 million each followed by India at approximately 100 million Muslims below poverty line. It is estimated that the ten Islamic countries at the bottom account for more than 600 million of the world's poor.

1.1. Microfinance Products

A commonly held view among observers of poverty alleviation programs across the globe is that provision of "appropriate" microfinance products and services to the poor in a sustained manner helps bring down

poverty levels. It is therefore, important to have a good understanding of what the poor need in terms of financial services.

The needs of the poor in Islamic countries are no different from the poor in other societies. They need financial services because they are often faced with events that call for spending more money than might be available with them. Experts generally point to three main categories of such events: life-cycle events, emergency needs, and investment opportunities. Life-cycle events include those once-in-a-lifetime occurrences (birth, marriage, death, home construction, old age) or recurrent incidents (education, festivals, and harvest times) that every household faces. Emergencies include personal crises like sickness or injury, the death of a bread-earning member or the loss of employment, and theft, as also natural calamities and disasters like earthquakes, floods and famines.

Opportunities to invest in businesses, land, or household assets also come up periodically. To come up with the financial outlays required by life-cycle events, emergencies, and opportunities, micro-credit is needed. Indeed the poor may need more than just credit. They need a range of services including credit, savings, money transfer facilities, and insurance in many forms.

Micro-credit:

Micro-credit as offered by conventional microfinance institutions (MFIs) in Muslim countries violates the fundamental prohibition of *riba* that the Islamic Shariah mandates.

While some poor Muslims, devoid of options and hard-pressed for cash may avail of interest-bearing credit, many prefer to stay away. As will be discussed in the following chapters, micro-credit may be offered using a variety of mechanisms that do not violate the Shariah. Islamic MFIs across the globe use a range of such Shariah-compliant mechanisms, such as, *qard hasan*, *murabaha* with *bai-bithaman-ajil*, *ijara*, *bai-salam* etc. All these modes create debt.

Micro-equity:

A micro-entrepreneur investing in a microenterprise may meet its financing requirements through debt or equity. Micro-equity provided to a first-generation micro-entrepreneur is called micro venture-capital (VC). Micro VC providers are however, far smaller in number and outreach. In an Islamic economy, several partnership-based modes of equity financing exist, such as,

trustee financing (*mudaraba*), joint venture (*musharaka*), share-cropping (*mudara*) and the like.

Micro-savings:

Poor people want to save. But they are constrained by the multiple demands on their low incomes and a lack of available deposit services that matches their needs and expectations. Poor people want secure, convenient deposit services that allow for small balances and transactions and offer easy access to their funds. Depositors – poor or rich – prefer high returns. They also want their deposits to score high on safety, security and liquidity. However, there is an additional dimension to the needs and expectations of Muslims in the matter of deposits. They want the returns to be permissible in Islam (*halal*) even while they may be using interest rates as a benchmark for comparison.

Micro-transfers:

Money transfers encompass more than just remittances, which are defined as the portion of migrant-worker earnings sent to family members or other individuals in their place of origin. Remittances include both domestic and international transfers. Massive numbers of poor people have relatives living and earning a living in distant places. They need services relating to sending and receiving money.

Micro-insurance:

Poor people, like other persons but probably more intensely, face a variety of risks and uncertainties, such as, death or sickness of the bread-earning member in the family, or loss of crops, livestock and housing due to natural calamities. These shocks are particularly damaging for poor households, because they are more vulnerable to begin with. Micro-insurance is the protection of low-income people against specific perils in exchange for regular monetary payments (premiums) proportionate to the likelihood and cost of the risk involved. As with all insurance, risk pooling allows many individuals or groups to share the costs of a risky event. To serve poor people well, micro-insurance must be responsive to priority needs for risk protection, easy to understand, and affordable. Several different types of insurance might be relevant for poor and low-income clients. According to most Islamic scholars insurance in the Islamic framework is ideally not-for-profit and takes the form of mutual guarantee by members in a cooperative venture called *takaful-tawuni*.

To sum up, microfinance implies provision of financial services to poor and low-income people whose low economic standing *excludes* them from formal financial systems. Access to services such as, credit, venture capital, savings, insurance, remittance is provided on a micro-scale enabling participation of those with severely limited financial means. The provision of financial services to the poor helps to increase household income and economic security, build assets and reduce vulnerability.

A large number of studies on poverty indicate that *exclusion* of the poor from the financial system is a major factor contributing to their inability to participate in the development process. In a typical developing economy the formal financial system serves no more than twenty to thirty percent of the population. The vast majority of those who are excluded are poor. With no access to financial services, these households find it extremely difficult to take advantage of economic opportunities, build assets, finance their children's education, and protect themselves against financial shocks. Financial exclusion, thus, binds them into a vicious circle of poverty.

1.2. Microenterprise Development

Central to the challenge of ending poverty is creating wealth through development of microenterprises. Microfinance is a critical input in this wealth-creation process. Microenterprises are generally put into two categories: livelihood enterprises and growth enterprises**.**

A livelihood (survival) enterprise is said to be one into which the entrepreneur is often pushed for want of more profitable alternatives, whereas one is attracted, or pulled into a growth (viable) enterprise by considerations of profitability, and is an entrepreneur by choice. Programs for developing livelihood enterprises have poverty reduction as their main objective. These programs seek to upgrade the productivity or increase the turnover of the multitude of livelihood enterprises and augment the income of the poor. They entail bringing about small improvements for many enterprises, often providing only credit, which is why they are sometimes characterized as being "minimalist." In contrast, growth-oriented microenterprise programs have enterprise development as their immediate objective and attempt to lift microenterprises to a qualitatively higher level of sustainability, setting them on the path to long-term growth, and seeking to provide a comprehensive range of

services, including credit, training, technical assistance, and the inculcation of business skills.[1]

The following are the key characteristics of livelihood enterprises:

- The enterprise is often one of many part-time or seasonal enterprises undertaken to supplement family income. Often seasonality is tied to crop cycle, school year, major festivals etc. It may be one of several "multiple" enterprises to compensate for seasonality and low returns. It uses mostly family labor with infrequent use of hired labor. It makes a secondary but vital contribution to family income.
- The enterprise usually involves no skills or very rudimentary skills, except for skills acquired traditionally, as in handicrafts. Therefore, there are very low-entry barriers to the activity resulting in overcrowding.
- Cases of surplus earnings are limited. Net earnings tend to be used for survival and ploughed back into household expenditure.
- A higher proportion of livelihood enterprises tend to be owned and operated by women.
- A higher proportion of livelihood enterprises are in livestock, backyard poultry, food processing, and petty trading.

As distinct from livelihood enterprises, growth enterprises usually involve the moderately poor or the graduated poor who have been largely successful in coming out of extreme poverty and destitution and are seeking to move upwards.

The following are the key characteristics of growth enterprises:

- The enterprise is often the main source of family income.
- The entrepreneur usually has some education. The entrepreneur needs to possess considerable experience and skills. This is more often acquired through vocational training and/or previous wage employment. The skill requirement restricts entry into such enterprises that are mostly in manufacturing and services sector.
- The enterprise often occupies "niche" market with considerable scope for specialization and product differentiation.

[1] Asian Development Bank (ADB) (1997), *Microenterprise Development: Not by Credit Alone*, Asian Development Bank, Manila, p36.

- Compared to livelihood enterprises, growth enterprises are less affected by seasonality and function throughout the year, even if at varying levels.
- Part of the surplus is reinvested in the expansion and growth of the enterprise. However, this is usually inadequate to meet the growing need for funds resulting in dependence on external capital.

Developing livelihood as well as growth enterprises is essential for any poverty alleviation initiative. As noted above, since entrepreneurs are poor, the surpluses in earnings generated by microenterprises tend not to be reinvested for expansion and tend to be applied instead to household expenditure. Therefore, they face a continuous need for external financing. At the same time, because of their poverty, micro-entrepreneurs often fail to provide collateral insisted upon by mainstream banks and financial institutions. Collateral is supposed to mitigate the risk of defaults and delinquencies. In the absence collaterals, mainstream financial institutions are reluctant to provide financing to such entrepreneurs. The main point of departure of microfinance from mainstream finance is its alternative approach to collateral.

1.3. Microfinance Models

Microfinance institutions provide to the entrepreneurial poor financial services that are tailored to their needs and conditions. Good microfinance programs are characterized by small, usually short-term loans; streamlined, simplified borrower and investment appraisal; quick disbursement of repeat loans after timely repayment; and convenient location and timing of services.

Microfinance institutions thus have distinct characteristics that make them specialized components of the financial system. The main point of departure of microfinance from mainstream finance systems is its alternative approach to collateral that comes from the concept of joint liability. In this concept individuals come together to form small groups and apply for financing. Members of these small groups are trained regarding the basic elements of the financing and the requirements they will have to fulfill in order to continue to have access to funding. Funds are disbursed to individuals within the group after they are approved by other members in the group. Repayment of the financing is a shared responsibility of all of the group's members. In other words they share the risk. If one defaults, the entire group's members face a setback. This is a basic but effectual credit scoring mechanism that may mean a provisional suspension from the program and therefore no access to financing for the group or other penalties. In most cases, microfinance programs are structured to give credit in small amounts and require repayment at weekly intervals and within a

short time period– usually a month or a few months. The beneficiary looks forward to repetitive financing in a graduated manner and this also helps mitigate risk of default and delinquency.

The model that has popularized the above methodology and has been replicated in many countries in a wide variety of settings is the **Grameen Bank** model. The model requires careful targeting of the poor through means tests comprising mostly of women groups. The model requires intensive fieldwork by staff to motivate and supervise the borrower groups. Groups normally consist of five members, who guarantee each other's loans. A number of variants of the model exist; but the key feature of the model is group-based and graduated financing that substitutes collateral as a tool to mitigate default and delinquency risk. In the country of its origin, i.e. Bangladesh, a Shariah-compliant replication has been attempted by Islami Bank Bangladesh Limited.

A second model that has been widely replicated mainly in Latin America and Africa is the **Village Bank** model. The model involves an implementing agency that establishes individual village banks with about thirty to fifty members and provides "external" capital for onward financing to individual members. Individual loans are repaid at weekly intervals over four months, at which time the village bank returns the principal with interest/ profits to the implementing agency. A bank repaying in full is eligible for subsequent loans, with loan sizes linked to the performance of village bank members in accumulating savings. Peer pressure operates to maintain full repayment, thus assuring further injections of capital, and also encourages savings. Savings accumulated in a village bank is also be used for financing. As a village bank accumulates sufficient capital internally, it graduates to become an autonomous and self-sustaining institution (typically over a three-year time period). This model has been successfully implemented in a Shariah-compliant manner in Jabal al-Hoss, Syria. A new experiment by FINCA in Afghanistan also seeks to implement this model.

The third type of MF model is a **Credit Union** (CU). A CU is based on the concept of mutuality. It is in the nature of non-profit financial cooperative owned and controlled by its members. CUs, mobilize savings, provide loans for productive and provident purposes and have memberships which are generally based on some common bond. CUs generally relate to an apex body that promotes primary credit unions and provides training while monitoring their financial performance. CUs are quite popular in Asia, notably in Sri Lanka. A variant of CUs are the member-based Islamic financial cooperatives in Indonesia called *Baitul Maal wat Tamweel* (BMT) that provide charity-based not-for-profit as well as for-profit financing.

A fourth model originating in India is based on **Self-Help Groups** (SHGs). Each SHG is formed with about ten-fifteen members who are relatively homogeneous in terms of income. An SHG essentially pools together its members' savings and uses it for lending. SHGs also seek external funding to supplement internal resources. The terms and conditions of loans differ among SHGs, depending on the democratic decisions of members. Typical SHGs are promoted and supported by NGOs, but the objective (as with village banks) is for them to become self-sustaining institutions.

It may be noted that while most of the models[2] described above practice conventional microfinance that is interest-based, there are also Islamic counterparts that seek to adhere to the Shariah. It appears therefore, that there is nothing in the microfinance models that makes them fundamentally inconsistent or incompatible with the Islamic values. . A subsequent chapter provides more details on implementation of the above models in a Shariah-compliant manner.

1.4. Microfinance Best Practices

These are principles of microfinance that reflect wisdom and lessons learnt from decades of "real-life" microfinance experiments. These are well-experimented and well-documented and made widely available among the global microfinance community. A significant contributor to this exercise has been the Consultative Group to Assist the Poor (CGAP), a multi-donor consortium dedicated to advancing microfinance. CGAP envisions a world in which poor people everywhere enjoy permanent access to a range of financial services that are delivered by different financial service providers through a variety of convenient delivery channels. As a way forward to realize this vision, CGAP has come up with a set of key principles of microfinance that together constitute the essence of "best-practices" microfinance[3]. These are as follows:

1. Poor people need a variety of financial services, not just loans. In addition to credit, they want savings, insurance, and money transfer services.

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[2] The four-model classification is based on John D Conroy, "The Challenges of Microfinancing in South-East Asia", *Financing Southeast Asia's Economic Development*, Institute of Southeast Asian Studies, Singapore, 2003.

[3] Brigit Helms, Access to All: Building Inclusive Financial Systems, Consultative Group to Assist the Poor, World Bank, 2006, P XI

2. Microfinance is a powerful tool to fight poverty. Poor households use financial services to raise income, build their assets, and cushion themselves against external shocks.
3. Microfinance means building financial systems that serve the poor. Microfinance will reach its full potential only if it is integrated into a country's mainstream financial system.
4. Microfinance can pay for itself, and must do so if it is to reach a large numbers of people. Unless microfinance providers charge enough to cover their costs, they will always be limited by the scarce and uncertain supply of subsidies from governments and donors.
5. Microfinance is about building permanent local financial institutions that can attract domestic deposits, recycle them into loans, and provide other financial services.
6. Microcredit may not always be the answer to development problems. Other kinds of support facilities may work better for people who are so destitute that they are without income or means of repayment.
7. Interest rate ceilings hurt poor people by making it harder for them to get credit. Making many small loans costs more than making a few large ones. Interest rate ceilings prevent microfinance institutions from covering their costs, and thereby choke off the supply of credit for poor people.
8. The job of government is to enable financial services, not to provide them directly. Governments can almost never do a good job of lending, but they can set a supporting policy environment.
9. Donor funds should complement private capital, not compete with it. Donor subsidies should be temporary start-up support designed to get an institution to the point where it can tap private funding sources, such as deposits.
10. The key bottleneck is the shortage of strong institutions and managers. Donors should focus their support on building capacity.
11. Microfinance works best when it measures—and discloses—its performance. Reporting not only helps stakeholders judge costs and benefits, but it also improves performance. MFIs need to produce accurate and comparable reporting on financial performance (e.g., loan repayment and cost recovery) as well as social performance (e.g., number and poverty level of clients being served).

To sum up, the principles broaden the definition of microfinance from microcredit to provision of an array of financial services, such as, savings, insurance and remittance. They emphasize that *access* and not *cost* of microfinance should be the main focus in designing and implementing a micro finance program for poverty alleviation. . The strategy should aim at

sustainability through a shift from a charity-based donor-dependent approach to a market-based for-profits approach emphasizing *systemic efficiency* and *transparency* and restricting use of donor funds to *capacity building*. The principles also underscore *inclusiveness* and *integration* of microfinance with the formal financial system.

In the subsequent chapters, it shall be demonstrated that there may indeed be many areas of commonality between the Islamic approach and the microfinance "best practices". The Islamic approach puts overwhelming emphasis on microenterprise development through financial and non-financial assistance and adherence to principles of transparency, empathy and cooperation. The Islamic approach is also more inclusive with a greater emphasis on the needs of the poorest of the poor.

1.5. Major Issues in Microfinance

Microfinance and Islamic finance have much in common. Both emphasize the good of society as a whole. Both advocate entrepreneurship and risk sharing and believe that the poor should take part in such activities. Both focus on developmental and social goals. Both advocate financial inclusion. Both involve participation by the poor. There are however, some points of difference between the two.

1.5.1. Financing for Economically Active

It may be noted that microfinance and especially micro-credit, is not usually appropriate for the chronically poor and destitute. Loans to the destitute may in fact make the poor poorer if they lack opportunities to earn the cash flow necessary to repay the loans. Indeed the other word for credit is debt. A destitute may be reluctant to incur debt and start a microenterprise because of risk and uncertainty with cash flows. Usually the individual may not possess entrepreneurial and technical skills needed for wealth creation. Such an “economically inactive” individual would be "unbankable" and would find it difficult to obtain financing from "for-profit" microfinance institutions. Indeed, more than financial services, these individuals must be provided for their basic needs, such as, food, shelter, or guaranteed employment. Such safety nets may be funded through charity. In an Islamic system, far greater priority is given to the needs of the chronically poor than those of the poor or the moderately poor or the not-so-poor. Islam provides for a mandatory form of charity - *zakah* that is called the third pillar of Islam - and many other voluntary forms of charity.

Therefore, of no less significance for poverty alleviation is creation of social safety net programs for poorest of the poor. In order to cross the skill-related barrier, such individuals would also need training for skills-development before they are able to make good use of microfinance. The safety nets may then be linked with microfinance programs, so that the same individuals may move through several stages – from abject penury to a stage where they are able to meet their consumption needs - then to a stage where they come to acquire necessary technical and entrepreneurial skills for setting up microenterprises - and then to a stage where they are able to obtain required funds from micro financing institutions (MFIs) and have the microenterprises up and running. Fighting poverty thus, would require an integrated finance-plus approach or the provision of financial services along with business development services and that is linked to social safety nets.

1.5.2. High Cost of Financing

Most conventional microfinance providers charge rates of interest that are found to be high when benchmarked against mainstream banking rates. Several reasons are usually given in defense. First, returns on investment in micro-enterprise are very high, by the standards of banks and other investors – the reason being the miniscule size of investments compared to the earning numbers. Hence, entrepreneurs can "afford" to pay high interest rates as cost of funds (sometimes as high as eighty percent) as long as the same are lower than rates of return. And those interest rates are much less important to microenterprises than access, timeliness and flexibility. Second, interest rates on microfinance are pegged relatively higher, since they entail higher administrative charges, monitoring costs and are by definition, riskier than a traditional financing portfolio.

There is indeed a general agreement on the issue that administrative and monitoring costs are higher with microfinance. While this partially might explain the differential in cost of financing of a microfinance portfolio as compared to a traditional portfolio, the method of financing need not be interest-based.

It is commonly believed that rates of returns on micro-projects tend to be quite high. However, the same is true only for the "successful" projects passing through "good times" and not true of all projects at all times. Interest related liability can compound and accentuate the financial problems of a project experiencing bad times and hasten its failure. The pace, frequency and intensity of such failure is directly related to the levels of interest rates. In case of Islamic profit-sharing mechanisms on the other hand, there is a clear

alignment between profitability of the project and cost of capital. The latter rises and falls in line with the realized profits of the venture. In case of Islamic debt financing too, the negative effects of financial risk arising out of use of fixed-rate financing are limited as compared to interest-based debt. This is because the former does not allow for compounding of the debt in case of possible default.

Interest rate – high or low, is rejected by Muslims as tantamount to *riba* – something that is prohibited in no uncertain terms by the Islamic Shariah. Indeed, financial exclusion is exacerbated in Muslim societies by their abhorrence to microfinance that is based on interest or *riba*.

1.5.3. "Women-Only" Approach

One of the potential benefits of microfinance in Muslim societies is the empowerment of Muslim women. While the ability of microfinance institutions to deliver financial services to rural women in gender-segregated societies is commendable, working with Muslim women is a sensitive issue that often raises accusations of meddling with social codes. Some Islamic microfinance (IsMF) institutions seek to overcome this through a shift in their focus from “women empowerment” to “family empowerment”. In a few other IsMF programs, a culturally appropriate way has been found of empowering women through gender-segregated ownership of the financing entity and involving separate appraisal of loan applications by women who develop their own gender-sensitive products and strategies for the future. One may note here that apart from weakening the institution of family, the "women only" approach of a few flagship microfinance institutions is fraught with grave risks. In traditional male-dominated Muslim societies the funds provided to women end up with the male members in the family while the women themselves end up carrying the business and financial risk.

In the forthcoming chapter, we discuss the Islamic approach and its various institutions and instruments to address the challenge of poverty. Predictably, safety nets, cost-less financing and skills improvement targeted at the “economically inactive” assume greater significance in the Islamic scheme of poverty alleviation.

Chapter 2

ISLAMIC APPROACH TO POVERTY ALLEVIATION

All principles or laws in Islam owe their origin to its holy book – the Quran and the sayings and deeds of its Prophet (peace be upon him) encapsulated in books of Hadith. A saying of the Prophet (peace be upon him) forcefully drives home the central message of Islam regarding poverty: "Poverty is almost like disbelief in God." On another occasion the Prophet (peace be upon him) is reported to have said "There is no asceticism in Islam". Islam views poverty to be a curse to be eradicated through productive efforts unlike some world religions and philosophies that celebrate asceticism. Poverty is in conflict with "enrichment of self (*nafs*)", which is one of the primary objectives (*maqasid*) of Shariah. Islamic jurists have unanimously held the view that it is the collective obligation (*fard kifayah*) of a Muslim society to take care of the basic needs of the poor. In fact, according to al-Shatibi, the noted Islamic scholar, this is the raison d'etre of society itself.[4]

2.1. Charity

Charity occupies a central position in the Islamic scheme of poverty alleviation. The broad term for charity in Islam is *sadaqa*. When compulsorily mandated on an eligible Muslim, *sadaqa* is called *zakah*. When *sadaqa* results

[4] M U Chapra (2008), *The Islamic Vision of Development*, Islamic Research and Training Institute, Islamic Development Bank

in flow of benefits that are expected to be stable and permanent (such as, through endowment of a physical property), it is called *sadaqa jariya* or *waqf*.

Zakah is the third among five pillars of Islam and payment of *zakah* is an obligation on the wealth of every Muslim based on clear-cut criteria. Rules of Shariah are fairly clear and elaborate in defining the nature of who are liable to pay *zakah*, at what rate *zakah* must be paid and who can benefit from *zakah*. There is total flexibility with respect to beneficiaries of voluntary *sadaqa* and *waqf*.

The primary issue with a *zakah* or *sadaqa*-based solution to the challenge of poverty is the issue of sustainability. Funds mobilized through these tools tend to fluctuate from time to time and may not lend themselves to careful planning and implementation. Further, these funds are meant mostly for the extremely poor and function as a safety net for meeting their immediate and basic needs. Benefits from *waqf* assets are of course, meant to flow to the community at large and also on a sustainable basis.

2.2. Economic Empowerment

While Islam strongly encourages charity from the giver's point of view, it seeks to minimize dependence on charity from the beneficiary's point of view and restricts the benefits to flow to the poorest of poor and the destitute, who are not in a position to generate any income and wealth.

A famous *hadith*[5] not only underscores the above, but also demonstrates how to design and implement a strategy of poverty alleviation through economic empowerment. The essence of the *hadith* is broken down into numbered statements so as to highlight the key principles and components of the strategy that follows from the *hadith*.

A man of the Ansar community came to the Prophet (peace be upon him) and begged from him. (#1)

He (the Prophet) asked: Have you nothing in your house? He (the man) replied: Yes, a piece of cloth, which we wear, or which we spread (on the ground), and a wooden bowl from which we drink water. (#2)

[5] Sunan Abu Dawood, Kitab al-Zakah, Book 9, Number 1637

He (the Prophet) said: Bring them to me. He (the man) then brought these articles to him and he (the Prophet) took them in his hands and asked to the assembly of people: Who will buy these? A man said: I shall buy them for one dirham. He (the Prophet) asked twice or thrice: Who will offer more than one dirham? Another man said: I shall buy them for two dirhams. (#3)

He (the Prophet) gave these to him and took the two dirhams and, giving them to the man of the Ansar, he said: Buy food with one of them and hand it to your family, and buy an axe and bring it to me. (#4)

He then brought it to him. The Prophet (peace be upon him) fixed a handle on it with his own hands (#5)

and said: Go, gather firewood and sell it, and do not let me see you for a fortnight. (#6)

The man went away and gathered firewood and sold it. When he had earned ten dirhams, he came to him and bought a garment with some of them and food with the others. (#7)

The Prophet (peace be upon him) then said: This is better for you than that begging should come as a spot on your face on the Day of Judgment. Begging is right only for three people: one who is in grinding poverty, one who is seriously in debt, or one who is responsible for compensation and finds it difficult to pay. (#8)

The components of this *hadith* can be seen to emphasize the following fundamental conditions of a successful microfinance program:

#1. *Access of the poorest of the poor to the program*: The Prophet (peace be upon him) was the spiritual as well as the political leader of the Muslims and he was accessible to the poor and the needy at all times for economic and financial assistance;

#2. *Careful assessment of the financial health of the poor; enquiry blended with empathy; insistence on contribution and beneficiary stake*: Many failed microfinance programs owe their failure to inadequate evaluation of the client's financial condition. Provision of microfinance does not stand to reason for a person in need of social safety nets resulting in the funds being consumed away instead of being invested. The poor come in disparate categories with varying needs of consumption and productive investment and risk of delinquency and default. Microfinance programs involving indiscriminate

funding of the poor, such as, most government-managed ones are destined to fail. This is one of the cornerstones of microfinance "best practices" that assert the government should have no role in direct or indirect provision of financial services and its role should be restricted to providing a supporting and enabling environment. Insistence on beneficiary stake is of course, a device to reduce moral hazard and enhance efficiency.

#3. *Transformation of unproductive assets of the beneficiary into income-generating ones through rigorous valuation (on the basis of price discovery through auction method); involvement of the larger community in the process*: Often the poor own high-market-value assets, such as, land in a prime city location without being able to derive income or benefit from the asset. While ownership of land does provide them with a bulwark against unforeseen adversities, this is an uneconomical and wasteful method of insurance. What is desirable here is a way to transform the unproductive asset into a productive one that could generate income. The original asset is not lost but transformed into an income-generating one. The price at which the original asset is disposed of must be fair and should not take the form of a distress sale resulting in loss of value to the seller. Contemporary finance theorists find the auction system to be the most efficient process of discovery of the intrinsic worth or the fair price. The involvement of larger community in the poverty alleviation program is also highly desirable for success of the program. For many contemporary successful MFIs, the right strategy is to involve grass-root NGOs in the process.

#4. *Meeting of basic needs on a priority basis and investment of the surplus in a productive asset*: Once again this highlights the need to take into account the consumption needs of the clients before expecting them to create wealth. The realization about the need for a social safety net and to link the same to microfinance at a later stage has come only recently in the microfinance industry.

#5. *Direct involvement of the program in capacity building in the run-up to income generation and technical assistance to the beneficiary; commitment of top management of the program*: This part of the *hadith* demonstrates a unique form of commitment and involvement on the part of the Prophet (peace be upon him) in the program of poverty alleviation. The involvement could not be more direct and the commitment more pure.

#6. *Technical assistance in the form of imparting requisite training to the beneficiary for carrying out the business plan/ income-generating project; monitoring through a time-bound schedule and impact assessment through a feed-back mechanism*: The need to establish an effective linkage between

financial assistance and technical assistance is emphasized among microfinance professionals as never before. Also the importance of impact assessment can be hardly overemphasized.

#7. *Transparent accounting of operational results and liberty to use part of income to meet higher needs*: Transparency through meticulous accounting and proper documentation is a fundamental requirement of financial transactions in the Islamic framework. As the holy Quran asserts:

"O ye who believe! When you deal with each other, in transactions involving future obligations in a fixed period of time, reduce them to writing" and "Let a scribe write down faithfully as between the parties" (2:282)

The import and significance of this verse is often not fully understood. Indeed, lack of proper documentation and accounting by beneficiaries is a major challenge confronting microfinance. Proper accounting and accurate measurement of results of operations or profits is a pre-requisite for profit-sharing based mechanisms. They are no less important for lending operations.

#8. *Strong discouragement to seeking charity*: Economic empowerment is the key word that rules out dependence on charity, which is permitted only for the poorest of the poor and those overburdened with debt or other obligations with no means of payment in sight.

2.3. Debt Avoidance

Islam permits debt. However, it recommends debt only as a last resort and not as a means to finance one's growing lifestyle needs. Muslims are warned against extravagance. The holy Quran says: "Eat and drink, but waste not by excess, for God loveth not the prodigals". (7:31) "Squander not wastefully, surely the squanderers are the devil's brethren." (17:26-27)

Muslims are also warned against the dangers of incurring heavy debt. The Prophet Muhammad (peace be upon him) used to regularly supplicate "Allah, I seek refuge with You from sin and heavy debt". When someone remarked, "how often you seek refuge from heavy debt", he replied, "when a man gets into debt, he speaks and tells lies, and he makes a promise and breaks it" (Bukhari and Muslim).

Muslims are exhorted to repay their debt in time and avoid deliberate delays. The Prophet Muhammad (peace be upon him) is reported to have said:

“The best among you are those who are best in paying off debt” (Muslim); “Procrastination in repaying debts by a wealthy person is injustice” (Bukhari).

Another *hadith* highlights the importance of an intention to repay in time and in full. It also warns against acquiring debt that one does not have the means or intention to repay. “Whoever contracts a debt intending to repay it, Allah will repay it on his behalf, and whoever contracts a debt intending to waste it, Allah will bring him to ruin” (Bukhari).

It follows from the above that one may incur a debt only if one is in serious need for it, and also with a clear intention and rational expectation about his/her ability to repay in full and in time. From the standpoint of the microfinance institution, the above has a strategic implication. Clearly, an Islamic MFI should refrain from seeking to entrap a client in ever-rising levels of debt, as may be the case with many contemporary MFIs.

2.4. Cooperation

Mutual cooperation and solidarity is a norm central to Islamic social behavior and collective ethics. The second verse of Surah Al Maida in the holy Quran says: "Assist one another in the doing of good and righteousness. Assist not one another in sin and transgression, but keep your duty to Allah" (5:2)

A *hadith* by the Prophet (peace be upon him) reinforces the principle of cooperation and mutual assistance. “Believers are to other believers like parts of a structure that tighten and reinforce each other." (Al-Bukhari and Muslim)

Following the above, an Islamic basis may be provided in favor of equity and partnership-based financing rooted in cooperation in contrast to debt-based financing. As highlighted in the previous section, Islam discourages debt. While Shariah-compliant debt-based modes are permissible, equity-based modes of financing are clearly preferred.

At times group-based financing and mutual guarantee within the group, a common feature of many successful microfinance experiments is also justified on the basis of Islamic ideal of cooperation. It should be noted however, that group-guarantees tied with financial interests may soon degenerate into group tyranny and oppressive behavior by economically and socially stronger members of the group, unless group formation and activity is accompanied with inculcation of Islamic spirit of solidarity, brotherhood and cooperation. This has already led to rethinking among some MFIs about the merits of group-based financing vis-à-vis financing of individuals backed by external guarantees.

Similarly, this norm appears to favor cooperation as a principle shaping the organizational structure and apparently points to a member-based structure as the preferred choice over other organizational forms in the Islamic framework. Indeed Shariah scholars permit insurance only when it is based on principles of mutuality and cooperation. Devoid of true Islamic cooperative spirit, however, member-based organizations tend to be characterized by political maneuvers and resultant low levels of professionalism. The idea of cooperation in essence highlights the need to ensure organization-wide good governance irrespective of its form and the importance of taking care of rights of all stakeholders.

2.5. Family Cohesiveness

Islam gives utmost importance to family as nucleus social institution that plays a major role in shaping the future of mankind. It also sees a balanced role for men and women in ensuring the economic and social well-being of the family.

The Quran declares that all human beings are created in pair. *"And everything have We created in pairs that you may reflect".(51:49)*

As stated earlier, the "women only" approach to microenterprise development and poverty alleviation is alien to Islamic religion and culture. The Quran promotes the concept of "family empowerment" by exhorting men and women to play their respective roles in seeking economic and social well-being of all members of the family. *"And covet not that whereby Allah has made some of you excel others. Men shall have a share of that which they have earned, and women a share of that which they have earned. And ask Allah of his bounty. Surely Allah has the perfect knowledge of all things" (4:32)*

2.6. Shariah Compliance of Contracts

Islamic microfinance products and services are essentially in the nature of contracts. All contracts in Shariah must be free from certain forbidden elements. A brief overview of relevant norms is provided below.[6]

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[6] For details on the norms of Islamic finance as well as their underlying rationale, readers may refer to the accompanying text *Introduction to Islamic Finance* by this author published by IBF Net.

2.6.1. Freedom from *Riba*

All forms of contracts and transactions must be free from *rib*a. The holy Quran declares:

- Allah has permitted trade and forbidden *riba*. (2:275)
- Allah will deprive *riba* of all blessing, but will give increase for deeds of charity: and Allah does not love the ungrateful and unjust. (2:276)
- O believers, fear Allah and forgo the interest that is owing, if you really believe. (2:278)
- If you do not, beware of war on the part of Allah and His Apostle. But if you repent, you shall keep your principal. Oppress none and no one will oppress you. (2:279)
- O Muslims, Do not devour *riba*, doubling and redoubling it and fear (the punishment) of Allah that you may be successful. (3:130)
- What you provide with the prospect of an increase through the property of (other) people, will have no increase with Allah; yet what you give in alms and charity, seeking the countenance of Allah, (will increase): it is these who will get a recompense multiplied. (30:39).

The holy *Quran* declares trade to be lawful means of livelihood as opposed to *riba*, which is forbidden for being oppressive and exploitative. It exhorts believers to shun *riba* and embrace charity. The exact nature of *riba* has been extensively discussed in Islamic literature. *Riba* in a loan or debt contract exists when it stipulates an excess in repayment by the borrower. An excess payment that is not a part of the contract and paid voluntarily by the borrower is not *riba*. There is a general agreement on modern interest being a form of the forbidden *riba*. The presence of interest makes most conventional financial contracts unlawful and unacceptable in Islamic microfinance.

2.6.2. Freedom from *Gharar*

The concept of *gharar* has been broadly defined by the Islamic scholars in two ways. First, *gharar* implies uncertainty. Second, it implies deceit. The *Quran* has clearly forbidden all business transactions, which cause injustice in any form to any of the parties. It may be in the form of hazard or peril leading to uncertainty in any business, or deceit or fraud or undue advantage. *Gharar* is considered to be of lesser significance than *riba*. While the prohibition of *riba* is absolute, some degree of *gharar* or uncertainty may be acceptable in certain forms of contracts. The presence of excessive *gharar* makes a contract forbidden.

Ibn Juzay, the well-known Maliki jurist provides a list of ten cases, which constitute, in his view, cases of forbidden *gharar*. These cases are described as follows.

(a) Difficulty in putting the buyer in possession of the subject-matter; such as the sale of stray animal or the young still unborn when the mother is not part of the sale.
(b) Want of knowledge (*jahl*) with regard to the price or the subject matter, such as the vendor saying to the potential buyer: "I sell you what is in my sleeve."
(c) Want of knowledge (*jahl*) with regard to the characteristics of the price or of the subject-matter, such as the vendor saying to the potential buyer: "I sell you a piece of cloth which is in my home." or the sale of an article without the buyer inspecting or the seller describing it.
(d) Want of knowledge (*jahl*) with regard to the quantum of the price or the quantity of the subject-matter, such as an offer to sell "at today's price" or "at the market price."
(e) Want of knowledge (*jahl*) with regard to the date of future performance such as an offer to sell when a stated person enters the room or when a stated person dies.
(f) Two sales in one transaction, such as selling one article at two different prices, one for cash and one for credit, or selling two different articles at one price, one for immediate remittance and one for a deferred one.
(g) The sale of what is not expected to revive, such as the sale of a sick animal.
(h) *Bai al-hasah*, which is a type of sale whose outcome is determined by the throwing of stones.
(i) *Bai munabadha*, which is a sale performed by the vendor throwing a cloth at the buyer and achieving the sale transaction without giving the buyer the opportunity of properly examining the object of the sale.
(j) *Bai mulamasa*, where the bargain is struck by touching the object of the sale without examining.

From the above, it is clear that *gharar* does not have a single definition and is a fairly broad concept. In modern parlance, *gharar* may simply refer to settlement risk. It may refer to inadequacy of information shared between parties to a transaction, such as, when the price, characteristics of object of transaction etc are not known to both the parties at the time of transaction. It may refer to misspecification and inaccuracy of information shared between parties to a transaction owing to fraud or deceit. It may also refer to undue complexity in transactions or simply games of chance.

It may be noted that *gharar* matters in the context of commercial transactions only. Similar conditions of *gharar* prevailing in the context of non-commercial transactions without a consideration, such as, grants, gifts, guarantees do not make the contract unlawful. For this reason, while commercial insurance is deemed unlawful because it involves *gharar,* mutual cooperative insurance is an acceptable product for Islamic microfinance.

It may also be noted that the prevalence of *gharar* poses a great challenge to an Islamic legal expert in the context of the informal setting of rural and micro economies with their non-standardized contracts of various types.

2.7. Islamic Norms and Microfinance Best Practices

While poverty eradication remains a cherished goal of Islam and microfinance "best practices" is there a degree of commonality too in their approaches and strategies to poverty alleviation? As mentioned in section 1.4, lessons from real-life experiences reflected in the microfinance best practices advocate a dual approach – use of charity as well as for-profit microfinance. At the same time, donor funds should complement private capital, not compete with it. The charity-based approach should be restricted to either providing temporary start-up support designed to get an institution to the point where it can tap private funding sources, or devoted to capacity building to take care of the shortage of strong institutions and managers. A charity-based approach is also needed for providing social safety net to the extremely poor and the destitute and therefore, unbankable. How does this compare with the Islamic approach to dealing with the poor and alleviating poverty?

Islamic approach to alleviate poverty involves a charity based intervention inherent in the institutions of *zakah* and *sadaqa* to take care of consumption needs of the extremely poor and the destitute and create a social safety net. The other institution of charity, the *awqaf*, is ideal for creation and preservation of assets that can build capacity and provide technical assistance for skill improvement and development of human resources. The social safety net and technical assistance are then linked to financial assistance. The financial assistance aims at wealth-creation using Shariah-compliant for-profit modes with free pricing. The entire process needs to be completely transparent with proper documentation, accountability and responsibility with a time-bound schedule. It seeks to bring economic empowerment for families as integrated units. The Islamic approach puts overwhelming emphasis on microenterprise development through financial and non-financial assistance and adherence to principles of transparency, empathy and cooperation. At the same time, various

microfinance products and services must not violate various Shariah norms and prohibitions.

The Islamic approach to poverty alleviation is more inclusive than the conventional one. It provides for the basic conditions of sustainable and successful microfinance, blending wealth creation with empathy for the poorest of the poor. It also follows that the Islamic approach is a composite of mission-based and market-based interventions. It favors equity-based and cooperation-based models in contrast to mechanisms that create and perpetuate debt.

Chapter 3

MISSION-BASED NOT-FOR-PROFIT MODES

Charity has played a major role in the birth and subsequent growth of the global microfinance industry. Large donations from international donor organizations have either provided the initial capital or helped meet the deficits of non-government organizations in the development sector, at least in the initial stages of their operations. Of late, there is a move towards reducing dependence of such institutions on donations and transforming them into sustainable microfinance institutions.

A mission-based approach to poverty alleviation and development in Islam involves several not-for-profit mechanisms, such as, *sadaqa*, *zakah*, *awqaf* and *qard-hasan*. The term *sadaqa* is broader in meaning. It implies charity. *Sadaqa* - when prescribed and compulsory on Muslims - refers to *zakah*. *Sadaqa* in its definition may include various forms of charity, such as, *tabarruat* (donations), *heba* (gifts), *infaq* (charitable spending) and may indeed connote any act of kindness and charity. When benefits from *sadaqa* are expected to continuously flow over future, it is called *sadaqa jaria* (perpetual *sadaqa*) and involves *waqf* or endowment of land, property and physical assets for charitable purposes. *Qard hasan* implies loans that are free from any benefit or return to the lender and is more commonly referred to as interest-free loan. We now turn to the specific institutions of *zakah*, *waqf* and *qard hasan*.

3.1. *Zakah*

Zakah is one of the fundamental pillars of Islam. *Zakah* literally means 'to purify, to develop, and, to cause to grow'. *Zakah* is the prescribed share of one's wealth to be distributed among the categories of those entitled to receive it. An individual entitled to pay *zakah* is called *muzakki* and the individual entitled to receive *zakah* is called *mustahiq*. Islamic microfinance programs aim at transformation of *mustahiq* into *muzakki* within a definite time frame.

3.1.1. Eligible Beneficiaries

Islam imposes restrictions on the use of *zakah* funds and requires that funds must clearly flow to specified categories of beneficiaries only. *Zakah* funds must be clearly distinguished from funds with Islamic treasury pooled through taxes and state revenues and cannot be used to finance infrastructural projects, public utilities and services beneficial to all Muslims - the poor and the rich - or for meeting the administrative expenditure of the state.

The following verse of the holy *Quran* defines the eligible beneficiaries *(mustahiqeen)* of *zakah*.

"The offerings (*zakah*) given for the sake of Allah are (meant) only for *fuqara* (poor) and the *masakeen* (needy), and *ameleen-a-alaiha* (those who are in charge thereof), and *muallafat-ul-quloob* (those whose hearts are to be won over), and for *fir-riqaab* (the freeing of human beings from bondage), and for *al-gharimun* (those who are overburdened with debts), and *fi-sabeelillah* (for every struggle) in Allah's cause, and *ibn as-sabil* (for the wayfarer): (this is) an ordinance from Allah- and Allah is all knowing, wise." (9:60)

Zakah is therefore, primarily in the nature of a safety net to take care of the basic necessities of life of those who cannot afford them. The first two categories, namely *fuqara* (the poorest of the poor) and *masakeen* (the needy and destitute) include individuals with no means of livelihood or inadequate income to meet their basic necessities of life that would include orphans, the sick and the disabled, and the homeless.

Zakah funds may also be used to defray the operational costs of managing a *zakah* organization. This is to maintain the integrity and the independence of collection and disbursement of *zakah* funds. The third category of eligible recipients of *zakah*, *ameleen-a-alaiha* refers to the personnel employed for this purpose and their salaries may be paid out of *zakah* funds.

Muallafat-ul-quloob, the fourth category, literally means people whose hearts are to be won over and implies such non-Muslims who are to close to understanding and perhaps accepting the truth and message of Islam. Under the fifth category *fir-riqaab zakah* may be used to pay ransom or compensation to buy freedom for slaves and prisoners of war.

Like the first two categories, the last four are quite relevant from the standpoint of a poverty alleviation initiative. The sixth category, *al-gharimun*, refers to individuals trapped in debt. It is important that such debt does not relate to frivolous and conspicuous consumption. It is also important that the default or delinquency in repayment of debt is not wilful and deliberate. Scholars also add qualifiers to debt eligible for *zakah* support, such as, that arising out of settling disputes among Muslims. Further, the amount of *zakah* that is paid cannot exceed the amount of debt.

The seventh category *fi-sabeelillah* is a fairly broad one and includes expenditure for the propagation and defence of Islam. It also includes expenditure on charitable projects in the field of education, medical care, and social welfare.

Finally the eighth category *ibn as-sabil* (son of the road / the way farer)) denotes any person who is far from his/her home who, because of circumstances beyond his/her control, does not have sufficient means of a livelihood at his/her disposal. In its wider sense it describes a person who, for any reason whatsoever, is unable to return home either temporarily or permanently, such as, a political exile or refugee. This allows for use of *zakah* funds for rehabilitation work in post-conflict regions.

There is a clear priority to the poor in the matter of *zakah* distribution. Scholars note that the *hadith* - in which Prophet Muhammad (peace be upon him) is reported to have said "*zakah* is to be collected from the rich and paid to the poor" – highlights the significance of this category. Also, there is a priority accorded to deserving people in the same locality from where *zakah* has been collected. It is also not necessary that *zakah* should be paid to all the eight categories of beneficiaries and is largely a matter of discretion. Indeed, in many instances an individual beneficiary may belong to more than one categories. Further, payment of *zakah* need not be widely dispersed among largest possible number of beneficiaries. An individual beneficiary may receive a relatively large proportion of one's *zakah* liability so as to pull him/her out of economic distress.

Zakah may be paid in cash or in kind. To ensure that *zakah* funds flow directly and only to a beneficiary deemed eligible by the Shariah, jurists emphasize on the principle of *tamleek*. The principle implies imparting direct ownership of *zakah* funds to the eligible beneficiary with all the attendant rights of ownership. Thus it rules out payment of *zakah* as a general contribution (to a welfare fund to cover its administrative overheads) and insists on ensuring actual flow of funds to the eligible individual beneficiaries. However, this does not imply that *zakah* can only be paid to private individuals and not to institutions. According to most contemporary scholars, *zakah* may be paid to institutional bodies taking care of the poor and the needy, such as, in providing them with education and health services.

3.1.2. Estimation of *Zakah*

Zakah is essentially a compulsory annual levy on wealth of an adult and sane Muslim individual who might possess wealth beyond a prescribed minimum. There is difference of opinion amongst scholars on whether this would also apply on organizations. For wealth to become liable for *zakah*, it must remain in the ownership of the *muzakki* for one Hijri calendar year (*haul*) and must exceed a minimum threshold (*nisab*). *Zakah* is not levied on income, which is used for consumption, and items of wealth, which are used for personal and family purposes. *Zakah* is levied on savings that is transformed into wealth of an individual and remains in its ownership for one calendar year, and on agricultural output. It is also levied on wealth that are characterized as stocks (e.g., gold, silver, the inventory of trade and livestock). *Zakah* is not levied on wealth that is in the nature of means of production, such as, tools and equipments, machinery etc. Islamic law provides for elaborate rules relating to estimation of *zakah* base (amount of wealth on which *zakah* is levied) and the rates of levy that vary with forms of wealth. With most forms of financial assets, the rate is two and half percent.

It may be noted that significant differences of opinion exist among scholars in matters related to *zakah*. For example, many scholars would like to see *nisab* as a dynamic rather than static concept. *Nisab* is the dividing line that separates the basic necessities of life from luxuries and therefore, changes with time and place. It basically provides for an acceptable standard of living, which covers all necessities of life, such as, food, clothing, house, household belongings, education, health care, means of transportation and as such, is relevant for a particular community at a point in time. Commenting on this, Dr Yusuf Al-Qaradhawi in his well-known treatise on legal rules of *zakah* notes:

"Unlike prayers, we observe that even the ratios, the exemption, the kinds of wealth that are *zakatable* are subject to differences among scholars. Such differences have serious implications for Muslims at large when it comes to their application of the Islamic obligation of *zakah*….There are new matters that did not exist in the past and were not known to the ancient jurists. These new matters require new religious injunctions."[7]

3.1.3. *Zakah* and Economic Empowerment

The primary objective of *zakah* is to pull a Muslim out of economic distress by providing for his/her basic needs. Basic needs by definition, are recurring in nature. It is therefore, pointed out by some that *zakah* proceeds must aim for economic empowerment and not for meeting their immediate consumption needs. The latter may indeed encourage dependence and make the poor permanently dependent on *zakah*. In their zeal to bring about economic empowerment, proponents often tend to undertake large investments in education, health care and other social welfare projects (benefiting the poor, the not-so-poor and even the rich) or engage in financing of microenterprises resulting in drying up of funds for meeting immediate consumption needs of the poorest of the poor.

Economic empowerment and meeting basic consumption needs need not be mutually exclusive. In any program of economic empowerment through *zakah*, satisfying immediate basic needs of the poorest of the poor must always be accorded top priority. In a subsequent phase, the beneficiaries may be made to go through skill-improvement programs through meeting their cost of education and training with *zakah* funds. *Zakah* funds may also be provided as start-up capital for their micro-enterprises either in the form of outright grants or loans (*qard hasan*) or micro-equity without expectation of returns depending upon the degree of their vulnerability. This would enable the poor to generate a sustainable means of livelihood and transform them from the category of *zakah* recipients (*mustahiq*) into that of *zakah* payers (*muzakki*). Such ambitious poverty alleviation and economic empowerment projects through efficient collection and distribution of *zakah* can be undertaken by the state or a not-for-profit organization like *Zakah* Fund.

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[7] Yusuf Al Qaradhawi (1995), *Fiqh Al-Zakah*, Translated by Monzer Kahf, Center for Research in Islamic Economics, King Abdulaziz University, Jeddah, Saudi Arabia

Box 3.1: Case of Ruma Zakat Yogyakarta, Indonesia

The peasantry which constitute more than forty-four percent of population of Indonesia, have experienced a process of marginalization and economic exploitation for decades. *Zakah* is expected to play a significant role in economic empowerment of these oppressed people. The Rumah Zakat is one of leading *zakah* organizations in Indonesia. Since May 2004, the Rumah Zakat Yogyakarta is operating an empowerment program called Jaring Pengembang Ekonomi Rakyat.

A study examines two kinds of *zakah* paradigms in the context of Rumah Zakat. It calls the first, a scriptural-conservative paradigm and the second, a substantial-transformative one. The scriptural-conservative paradigm refers to the formal and conventional understanding of *zakah* as reflected in classic works of *fiqh*. The substantial-transformative paradigm of *zakah* refers to modern interpretations of *zakah* highlighting its pivotal role in ensuring socio-economic justice. The study advocates the latter paradigm. It gives an interesting example of a group of peasants operating a chicken husbandry program financed through interest-free loans by Rumah Zakat to illustrate the difference in the paradigms. When the peasants were asked why they proposed chicken husbandry program instead of a program related farming management or the development of agricultural sector, they said that the agricultural sector was not promising a better life for the peasantry. One of the peasants summed it up succinctly: "tuku larang, adol murah" (too high a price when you buy, too low a price when you sell), meaning that the cost of agricultural output cannot cover the cost of inputs. As a consequence, the peasantry often suffers financial losses. When they were asked why it happened, they had no clue. Even the supervisor appointed by Rumah Zakat for the group knew nothing about the cause of the peasantry's problems in Indonesia. Indeed, the supervisor had established regular meetings with the group, but the meetings were more for religious teachings. The task of the supervisor was limited to monitor whether the peasants still worked on their husbandries and to ensure that the peasants could return the money back within the time limit.

The situation of Indonesian peasants qualifies them as the poor (*al-masakin*) as well as oppressed and marginalized people similar to those in slavery (*fi al-riqab*). The Rumah Zakat in a scriptural-conservative paradigm, considered the peasants only as the poor (*al-masakin*). No wonder its empowerment program for the peasantry just assisted the peasants to meet their basic needs. It did not see exploitation and unfair structure as the roots of peasant problems. The organization saw no need to directly challenge peasant exploitation because it did not see them as in oppressive systems (in slavery).

Source: Dani Muhtada "The Role of Zakat Organization in Empowering the Peasantry: a Case Study of the Rumah Zakat Yogyakarta Indonesia" in *Islamic Finance for Micro and Medium Enterprises* (2008), ed. M. Obaidullah and Abdullateef S, IRTI, Islamic Development Bank, Saudi Arabia

Economic empowerment is a much broader concept than enhancement of income. It aims at social transformation of the poor and ensure social justice. Indeed most scholars agree that this is the purpose of the institution of *zakah*. Yet, a narrow scriptural interpretation of the rules of *zakah* could leave the problem remain unaddressed as brought out in the case of Ruma Zakat Yogyakarta, a leading *zakah* institution in Indonesia (see Box 1)

3.1.4. Management of *Zakah* Funds

From a microfinance perspective, management of a *Zakah* Fund raises two important issues. The first issue relates to whether the poor should be provided grants or loans. It is pointed out that the flow of *zakah* funds in contemporary Muslim societies is extremely inadequate and erratic. Providing revolving credit through *qard hasan* loans out of pooled *zakah* proceeds ensures that the Fund is now automatically replenished every time loans are repaid. The outcome is a sustainable Shariah-compliant financial service provider for the poor. Notwithstanding the sustainability argument, the fact remains that micro-credit (even without interest) is not for the poorest of the poor. The extreme vulnerability of this section of the society makes them reluctant to opt for loans. Those who venture, are confronted with the possibility of remaining in debt for extended periods if liberal waivers are not granted to them in case of inability to pay in the true spirit of *qard hasan*. Indeed this violates the very essence of *zakah* - of pulling an individual out of indebtedness.

The sustainability argument is also used to justify a policy of investing *zakah* funds in *mudaraba* and other Shariah compliant investments. While this is lawful, it may be desirable only in case of provision of start-up capital to the poorest of the poor and not with a view to generating maximum returns on investments. In case of existence of undistributed surplus (a highly unlikely scenario in the presence of large-scale poverty in Muslim societies) these may be invested for temporary periods, but must avoid high risk avenues.

3.2. *Waqf*

A *waqf* (plural: *awqaf*) is an inalienable endowment in Islam. It implies holding certain physical assets and preserving it so that benefits continuously flow to a specified group of beneficiaries or community. There is a prohibition on its use or disposition outside its specified purpose. A dominant characteristic of *waqf* is "perpetuity". Therefore, waqf typically applies to non-perishable properties whose benefits and usufruct can be extracted without consuming the property itself. *Waqf* mostly involves devoting a land or building for religious or charitable purposes. However, some scholars also permit *waqf* of books, agricultural machinery,

livestock, shares and stocks and even cash. This is deemed acceptable under the condition that the physical asset itself is not depleted with flow of benefits from such assets. A cash *waqf* thus, is conceivable where the original endowment is kept intact and the returns generated from the endowment is used for the stated purpose(s).

Waqf is a *sadaqa jariya* (running charity). It is distinct from ordinary *sadaqa*, the point of difference being the repeatability of the benefits that flow out of it. Doing a *waqf,* unlike *zakah*, is purely a voluntary act. Like ordinary *sadaqa, waqf* is flexible in the sense that its beneficiaries need not be restricted to Muslims only. The institution of *waqf* draws its inspiration from the spirit of giving contained in *Quranic* verses, such as, “You shall never attain piety/righteousness until you give from what you love” (3:92) It is reported that with the revelation of the aforementioned verse, a large number of companions of the Prophet (peace be upon him) began making *awqaf* of their best and most valuable properties. According to a report in the well-know treatise *Al-Mughni* by Ibn Qudama, all companions of the Prophet (peace be upon him) who were financially capable of doing so, made *waqf*.

3.2.1. Characteristics and Rules of *Waqf*

Scholars consider *awqaf* in three categories. The first category – religious *waqf* - refers to mosques and properties confined for providing revenues to be spent on their maintenance and recurring expenses. The second category – philanthropic *waqf* - aims at providing benefits to the poor segments of the society. All programs and activities that are of interest to people at large, such as, provision of education, training, health care, care of animals, environmental protection and microfinance can be undertaken by philanthropic *waqf*. The first philanthropic *waqf* in the history of Islam came into existence when Prophet Muhammad (peace be upon him) instructed his companion Othman (r) to purchase the well of "Rumah" in Madinah and make a *waqf* of the same. Its purpose was to ameliorate the difficulty that the poor in the city were facing in procuring highly-priced drinking water. The third category of *waqf* is called family *waqf* under which the children and descendants of the endower (*waqif*) have a first right on the benefits and revenues of the *waqf*. Only the surplus, if any, should be given to the poor. Clearly to achieve the goal of poverty alleviation, the philanthropic *waqf* can play a major role.

Waqf is a historical institution. Rules governing *waqf* are fairly elaborate and well-documented. The rules essentially aim to protect these *awqaf*, to provide conditions for their development and expansion, to ensure that the income of the *awqaf* is spent in accordance with the intentions of the endower (*waqif*) and the

trustee-managers (*mutawallis*) perform their responsibility diligently and with integrity.

A basic characteristic of *waqf* is perpetuity or permanence. A *waqf* property cannot be sold or transferred under normal circumstances. Elimination of the *waqf* character off a property requires difficult and lengthy legal procedure. Under conditions where this may be deemed highly desirable, scholars put stringent conditions under which this may be effected. It requires a process of exchanging the *waqf* property for another property of equivalent value with approval of a local court. Upon completion of such an exchange the new property must be dedicated as *waqf* for the same purpose and beneficiaries as the former property.

Since *waqf* is a voluntary act of benevolence, conditions specified by the founder must be fulfilled to their letter as long as they do not contradict or violate any of the Shariah rulings. This implies that revenues of *waqf* should exclusively be used for the objectives and in accordance with the stipulations of its founder (*waqif*). The *waqf* document contains all the stipulations of the founder (*waqif*). If the objective(s) of a *waqf* become irrelevant or infeasible, its revenues should then be spent on a closest avenue available. If such an avenue is not present, then the revenues would be directed to the poor and the destitute.

The management of a *waqf* is undertaken in accordance with the stipulations of its founder by a trustee or manager called *mutawalli* or *nazir* who is required to administer the *waqf* property in the best interest of the beneficiaries. The primary responsibility of the *mutawalli* however, is preservation and protection of the property, followed by maximization of the benefits or revenues of the beneficiaries.

It is pertinent to note that rules of *waqf* have historically evolved with the primary purpose of protecting and preserving the *waqf*, which is a gift to the Almighty, often from usurpers (corrupt practices of *mutawallis* or external aggressors) and also to protect the original purpose and stipulations of the founder (*waqif*). A case in point is the large-scale interference and control of *waqf* property by the state on the above grounds, ignoring the original stipulation of the founder regarding the management of *waqf*. Contemporary scholars advocate a minimum role of the state in *awqaf* matters and assert the need for efficient management of *awqaf* properties for maximizing benefits for the stated beneficiaries. An excellent example of this is the Indian situation where the institution of *waqf* has largely failed to have any positive impact on conditions of the large sections of poor and destitute among Indian Muslims.(See Box 3.2).

Box 3.2. Developing *Waqf* Properties in India

According to the Report of the Sachar Committee (2005) appointed by the government of India to look into economic and social conditions of Indian Muslims, "the current market value of *awqaf* properties in India is INR 1.2 trillion, (a quarter of India's gross tax collection in 2006-07). There are approximately half a million registered *waqfs*, and many have multiple properties, mostly in prime urban areas. It also notes that if these properties are put to efficient and marketable use, they can generate a minimum return of 10 percent, which is about INR 120 billion per annum. As against this, their current earnings total a meager INR 1.63 billion. It is worth mentioning here that wherever the *waqf* lands have been put to efficient use, they have generated an average return of 20 percent. While these are endowments for specified charity and theoretically the property belongs to Allah, managed by *Mutawallis*, in practice, the managers have turned into usurpers and have tended to virtually act as owners of the properties and used them in a large number of cases for private gain or social and political dominance."

Do the rules of *awqaf* permit development of *awqaf* property? According to the Resolutions of Islamic Fiqh Academy (India) at its Tenth Fiqh Seminar on *Awqaf* Issues held in October 1997 at Mumbai, India:

"In a situation where the income of a *Waqf* is quite sufficient, it is not suitable to sell it off just for the purpose of generating more and more income because there is ample risk of loss of the original *Waqf*. Albeit, if the income generated out of the endowed property is so insufficient and meager that even the necessary expenses of the *Waqf* property remain unfulfilled and funds need to be borrowed to make it functional and, moreover, there lies no other alternative in question to enhance its income under such grim circumstances, the endowed property might be sold off under the conditions mentioned earlier to buy a more beneficial and profitable property. However, if the *waqif* (endower) is alive, his consent should also be obtained before striking a deal…..Those *Awqaf* whose buildings have become old and are in a dilapidated condition and the *Awqaf* does not have enough funds to repair it, neither is there any bright chance in the near future, then the *Mutawallis* of the *Awqaf* can, enter into an agreement with some builder with a precondition that he should construct the building and then keep the whole building or a part of it on rent for a certain defined period of time. In this way he would get the benefits of his investments. Nonetheless, it would be of course, inappropriate to pass off the ownership rights of one or two storey's of a multi-storied building to the builder forever."

Contemporary scholars also advocate a more flexible approach in interpreting rules of *awqaf*. According to this view, since the *fiqh* of *waqf* is mainly analogy-based as we have very few texts that deal with the details of *awqaf*. The classical scholars of *fiqh* often take stiff positions on several issues to an extent that

hinders the development of a progressive Shariah-based legal framework of *awqaf*. For example, although the principle of perpetuity is of high importance for *waqf* because it assure the historical accumulation of the *waqf* properties, it is sometimes carried too far to an extent that restricts certain acts of benevolence. Similarly, rigid adherence to classical positions provides no room for cash or monetary *waqf*, *waqf* of a flow of commodities or of financial rights. If *waqf* is to play a catalytic role in poverty alleviation through education, training leading to skills-improvement and capacity building, then one clearly sees merit in the following possibilities as examples: *waqf* of use of a building for ten years, *waqf* of copyrights of books by an author, *waqf* of subscription to a research journal for five years, *waqf* of a known percentage of salary every month for five years and so on.

Box 3.3. The Ottoman Cash *Waqf*

An Ottoman cash *waqf* was established by a generous person, who endowed his savings in the form of cash for a charitable purpose. This cash was then lent to various borrowers. The number of these borrowers usually did not exceed 20. As collateral, the borrowers transferred the ownership of their houses to the *waqf*, which allowed them to continue using their homes. In return, the borrowers paid rent to the *waqf* for as long as they kept its capital. Once they paid back the money they borrowed, the ownership of the collateral reverted back to them. The total amount of rent paid to the *waqf* constituted the profit and was divided into three parts: the first part was used to finance the charitable purpose for which the *waqf* was established in the first place; the second part was used for administrative expenses and the last part was added to the original capital so as to protect it from inflation. Some cash *waqfs* could also enhance their original capital by the donations made by other cash *waqfs*.

Although ultimately the endowed cash was earning cash, i.e., a cash-cash transaction and therefore constituted potentially a usurious transaction, the fact that the cash earned by the *waqf* was in the form of rent for a pawned real estate, transformed the whole process into a perfectly legal transaction. In short, cash *waqfs* obeyed the letter of the interest prohibition. But since the endowed cash yielded a fixed return, which hardly changed over the long term, in fact, economically, the yield was very close to ordinary interest. An Ottoman cash *waqf* usually lent small amounts to people with modest means. Thus they may be considered as the origin of the contemporary micro-credit institutions.

Source: Murat Cizakca (2007), "Incorporated Cash *Waqfs* and *Mudarabah*: Islamic Nonbank Financial Instruments from the Past to the Future" in *Non-Bank Financial Institutions: Islamic Alternatives*, Ed. Habib Ahmad, Islamic Research and Training Institute, IDB, Jeddah

Cash *waqfs* have always involved a divergence of opinion among scholars. A cash *waqf* is a charitable endowment established with cash as the corpus, and not real estate as in case of traditional property-based *waqf*. The revenue generated out of the investment of this cash is then channeled for charity. Modern scholars permit a cash *waqf* established with the shares of incorporated joint-stock companies. The main line of argument against cash *waqf* is that the ownership of the corpus, once endowed, lies with Allah (swt). When the *corpus* of a cash *waqf* is used for *mudaraba* or dispensed as *qard*, the cash endowed is inevitably distributed to the borrowers. This is not permissible, since what belongs to Allah (swt), cannot be distributed to third persons. Notwithstanding this, cash *waqfs* became quite popular during the Ottoman era. The Ottoman arrangement known as *istiglal* ensured that only the right to utilize the *waqf* capital, usufruct, was distributed to the borrowers, not the ownership. The latter is protected by a hefty collateral usually in the form of the borrower's house. (see Box 3.3)

It may be noted that many of the contemporary not-for-profit organizations bear a resemblance to *waqf*, the notable one being the Trust under English law. These may be seen as "*waqf*-type" entities that play a role similar to a *waqf* in any poverty-reduction initiative. There are various forms of such "*waqf*-type" entities, such as, not-for-profit companies, foundations with minor variations due to different legal jurisdictions in which they operate. There are important differences, however between *awqaf* and the "*waqf*-type" entities. The management of a corporation, for example, with proper authorization from its constituency, the general assembly, can dispose of the assets of the corporation through sale, gift, and other ownership transferring transactions. It can also liquidate the corporation and do away with all of its properties. The managers of *awqaf* enjoy much less freedom. They cannot consider sale or transfer of properties without a solid justification and must follow certain rigid procedures. They cannot even give any of the *waqf* income to any philanthropic objective outside the stipulated one. [8] It is pertinent to note here that many Islamic charities prefer these "*waqf*-type" organizational forms due to a variety of reasons, such as, absence of *waqf*-specific laws, lack of clarity and unnecessary rigidities with local *waqf* laws where they exist, ease and convenience in dealing with officials conversant with mainstream laws and regulations, avoiding government interference and control of *waqf* properties and the like.

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[8] The section on fiqhi aspects of waqf draws on Monzer Kahf, *The Role of Waqf in Improving the Ummah Welfare*, Paper Presented at the International Conference on Integrating Awqaf in the Islamic Financial Sector, held during March 06-07, 2007 at Singapore.

3.3. *Qard Hasan*

Qard hasan literally means a beautiful loan. It is a loan granted by the lender without expectation of any return on the principal. The following verses from the holy *Quran* reveal the importance of this institution. A *qard hasan* to a needy person is equated to a loan to Allah (swt) Himself and the loan would be repaid by Allah (swt) many times multiplied. There is also no indication in verses that the rewards of *qard hasan* promised by Allah swt are meant for the hereafter only.

- Who is it that will lend Allah a *qard hasan* which He will multiply for him (the lender) many times and for him shall be a generous recompense (11:57)
- Verily, those who give *sadaqa*, men and women, and lend to Allah a *qard hasan*, it shall be increased manifold (to their credit), and theirs shall be an honorable good reward. (57:18)
- If you lend Allah a *qard hasan*, He will multiply it for you. Allah is the most appreciating, the most forbearing (17:64)

From the above verses it is clear that Islam provides very strong incentives for lenders to meet the financial requirements of the needy by providing loans without expecting any gain in return from them. Any such return expected or demanded by the lender is forbidden *riba*. It is pertinent to note here that the Prophet (peace be upon him) also exhorted a borrower to be generous when he repays. He is allowed and indeed, encouraged to return more than he originally borrowed from the lender. The excess is viewed as a gift (*heba*) from the borrower and is permissible as long as it is not demanded (stipulated in the contract) by the lender.

A Muslim is also encouraged to avoid debt. He should strive to get out of debt if he is already trapped in it. He must make all efforts to repay his loan as early as possible. At the same time Islam encourages a lender to give extension in time or waive part of the loan, should the borrower be forced to default. It completely rules out any penalty for default that is unintentional. However, in case of willful default or delinquencies, a penalty may be imposed as a deterrent. Such penalty, once collected, must be donated to charity and cannot form part of the income of the lender.

From the standpoint of a microfinance institution, a *qard hasan* may be seen both as an instrument of savings mobilization and financing. In legal and financial terms, a *qard hasan* is a loan contract with zero nominal returns. It is pertinent to note here that a microfinance institution may not stipulate any return

in its savings scheme, but still try to circumvent *riba* prohibition by making a gift on its savings plans at regular intervals. This is justifiably frowned upon by Shariah scholars, as such a practice would inevitable lead the savers to expect a gift every time they deposit their savings with the microfinance institution on a *qard hasan* basis. This is tantamount to *riba*.

A *qard hasan* may or may not have a date of redemption. The absence of a specific date of redemption gives a right to the lender to call for repayment any time he wants. The borrower in a *qard hasan* is required to repay the loan in part or in full as and when demanded. This feature transforms *qard hasan* into a powerful instrument of savings mobilization. When the deposit contract is modeled as a *qard hasan* contract, the depositors as the lenders can take back their deposits with the microfinance institution anytime they desire. Therefore, they are expected to be interested in placing their surplus funds with the institution on a *qard hasan* basis even if there is no nominal return on their savings. This would provide security to their savings and at the same time, enable them to perform a supreme Islamic duty of helping the have-nots. This logic underlies the establishment of *Qard Hasan* Funds in Iran on a fairly large scale. (Box 3.4) The success of these Funds provides solid evidence against a long held myth in the financial services industry that the Islamic depositor is as concerned about returns as its conventional counterpart.

As a financing mechanism by a microfinance institution, *qard hasan* offers several advantages too. It places cash in the hands of the borrower that may be used by him for consumption as well as productive purposes. As experience has shown, linking credit invariably to microenterprises may prove to be counterproductive and the current thinking favors a financial services approach to tackling poverty, that does not distinguish between borrowing for consumption or productive purposes. After all, a borrower whose consumption needs remain unfulfilled can hardly be expected not to divert funds from productive purposes to consumption purposes.

When a microfinance institution provides loans on the basis of *qard hasan*, it is allowed to recover the cost of operations from the borrower. Such excess charge based on actual costs of operations is not same as prohibited *riba*, according to most scholars. As a check against such permissible service charge degenerating into *riba*, scholars insist on delinking the quantum of service charge with time or quantum of the loan. Further, charging the borrower on the basis of actual operational costs also requires that any excess charge may be refunded back to the borrower after the actual operational costs are ascertained at the end of the accounting period. Extending the logic further, one may make a case in favor of microfinance programs that apparently are interest-based, but

the interest rates are not just below-market, but pegged so low that a part of the actual operational cost associated with the program remains uncovered.

Box 3.3. *Qard Hasan* Funds in Iran

Qard Hasan Funds are operating in the Iranian informal financial sector for the past two to three decades. It is estimated that currently more than 3000 funds of these types operate in urban and rural areas of the country. *Qard Hasan* Funds can be divided into at least four categories: Family *Qard Hasan* Funds, Workplace *Qard Hasan* Funds, Community or Village *Qard Hasan* Funds and large *Qard Hasan* Funds.

In principle, all forms of *Qard Hasan* Funds are non-profit institutions in which members of a community set up a savings and loans society. Members deposit their savings with the fund in order that other members who need some loan for a short period could be helped from this fund. This is a mutual support fund — a depositor at one time may become a borrower at another time and vice versa. Members are free to withdraw some or all of their deposits if and when they want (or at short notice). No depositor demands or receives any amount in addition to his/her capital. As the members are known to each other and trustworthy, there is no room for default on loans. The operations of the society are run by volunteers, using some free office space. Other overheads, such as, costs for stamps, stationery, transport, communication and so on are covered, in some *Qard Hasan* Funds, through engagement of funds in business activities. In most of the others, the borrowers have to pay the costs. Therefore, even though the capital is cost-free the loan is not. It is *riba*-free but not cost-free.

Most of *Qard Hasan* Funds only accept current and saving deposits. Similar to banks, the current deposits can be withdrawn at any time. The checks issued by *Qard Hasan* Funds, however, are not official and legally viable and only some other Funds accept these types of checks. Saving deposits are deposited by individuals or companies. These are the most common type of deposits in *Qard Hasan* Funds. Studies show that the average amount of saving deposits in *Qard Hasan* Funds is larger than those of banks.

Loan applicants of *qard hasan* usually request loans for needs like marriage, health, or housing. Depending on the size of the loan and borrowers' ability to pay, borrowers have between 1 to 2 years to repay the *qard hasan* loans. To be eligible for a *qard hasan* loan, a borrower must be in urgent need, have at least one referee or guarantor, and demonstrate sufficient evidence to repay the loan. The total amount of loans provided by *Qard Hasan* Funds have been estimated to be much more than those provided by the commercial banks in Iran.

Source: Ali Asgary (2007), "Informal Microfinance Institutions: Case of Qard Hasan Funds in Iran " in *Non-Bank Financial Institutions: Islamic Alternatives*, Ed. Habib Ahmad, Islamic Research and Training Institute, IDB, Jeddah

3.4. A Non-Profit Model of Microfinance

So far, we have discussed three major non-profit modes of Islamic microfinance – *zakah*, *awqaf* and *qard hasan*. We now combine them into a model of microfinance. This is a model that uses non-profit modes only, but may be easily modified to incorporate for-profit modes as well. The model is presented in Figure 1 below.

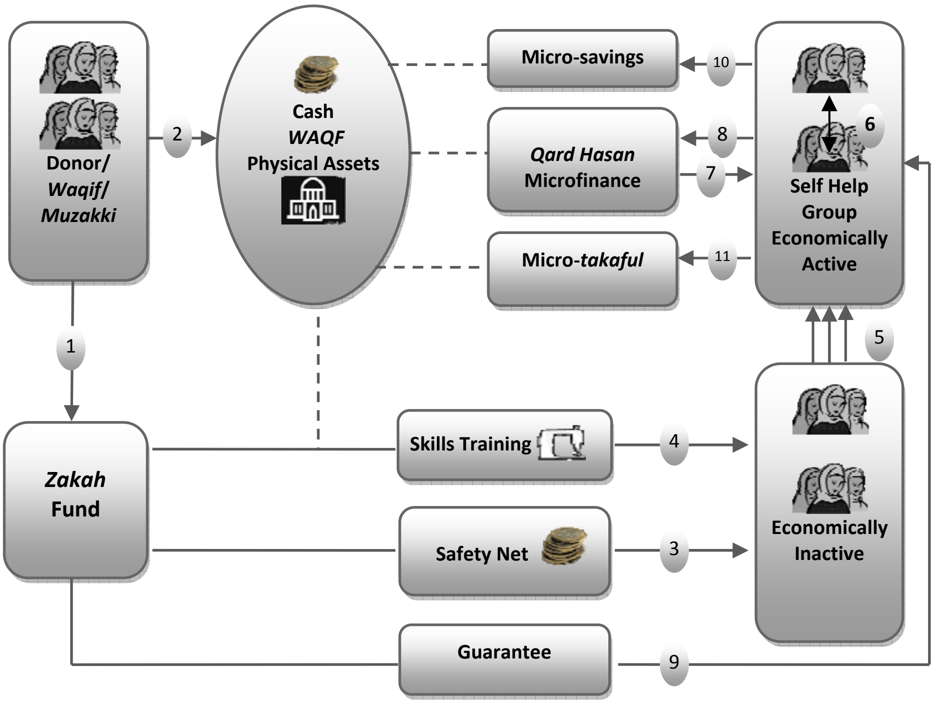


Figure 1: Model of microfinance using Islamic not-for-profit modes

The model may be described in terms of activities 1-11 as follows:

1. Islamic Microfinance Institution (IsMFI) or Program creates a *Zakah* Fund with contribution from *muzakki*;
2. Program facilitates *Waqf* of physical assets as well as monetary assets. The physical assets are used to facilitate education and skills training. The monetary assets may be in the form of a cash *waqf*, or simply as ordinary *sadaqa*;

3. Program carefully identifies the poorest of the poor and the destitute who are economically inactive and directs a part of *Zakah* Fund towards meeting their basic necessities as grant, seeks to provide a safety net;
4. Program provides skills training to economically inactive, utilizing community-held physical assets under *waqf*;
5. Beneficiaries graduate with improved skills and managerial acumen;
6. Beneficiaries are formed into groups with mutual guarantee under the concept of *kafala*;
7. Financing is provided on the basis of *qard hasan* to the group; also to individuals backed by guarantee under the concept of *kafala*;
8. Group members pay back and in turn, are provided higher levels of financing;
9. Additional guarantee against default by the group is provided by the *Zakah* Fund and actual defaulting accounts are paid off with *zakah* funds; this is indeed the distinct feature of this model[9];
10. Group members are encouraged to save under appropriate micro-savings schemes;
11. Groups members are encouraged to form a *Takaful* Fund to provide micro-insurance against unforeseen risks and uncertainties resulting in loss of livelihood, sickness and so on;

The distinguishing feature of this model, not hitherto discussed, is the use of *kafala* as a guarantee mechanism at the group or individual level. *Kafala* also forms the basis of designing a mutual guarantee (*takaful*) scheme against specific risks and uncertainties. For details on alternative models of *takaful*, readers may refer to the accompanying text *Introduction to Islamic Finance* by this author published by IBF Net.

9 For a justification and elaboration of this idea, see Zarka, M.A., *Leveraging Philanthropy: Monetary Waqf for Micro Finance*, Paper Presented to a Symposium on Islamic Micro-Finance at Harvard Law School, Harvard University in April 2007.

Chapter 4

MARKET-BASED FOR-PROFIT MODES

Islamic approach to poverty alleviation is a composite of a mission-based and market-based interventions. Microfinance in Islam need not be restricted to not-for-profit modes alone. Islam permits for-profit trade and creation of wealth. In terms of the earlier model of microfinance that uses not-for-profit modes only, it is easy to see that the poor who fall into "economically active" category may be provided financing using for-profit modes as well. The members of such groups do not belong to the extremely poor or the destitute category and are in a position to create wealth for themselves, for the Islamic Microfinance Institution (IsMFI) and for the society. For-profit financing provides financial sustainability to Islamic Microfinance Institutions (IsMFI).

As discussed in Chapter One, the poor need a range of microfinance services, such as, micro-savings, micro-credit, micro-equity, micro-*takaful* and micro-remittance. In the context of mainstream Islamic finance, we come across a host of for-profit modes through which such services may be provided to the poor. These could be used for microfinance with minor modifications wherever needed. A detailed discussion of the modes is beyond the scope of this monograph. A reader interested for the same may find it in the accompanying text *Introduction to Islamic Finance*. In this monograph we focus on specific applications of these modes in microfinance and the issues therein. We begin with micro-savings products.

4.1. Micro-Savings

Micro-savings is a critical financial service for poor and excluded households. Poor people want secure, convenient deposit services that allow for small balances and transactions and offer easy access to their funds. However, microfinance institutions across the globe tend to neglect this product while giving undue importance to micro-credit.

Micro-savers are motivated by a host of factors, such as, safety, convenience, returns, personalized service (door-to-door collection) etc. An additional dimension in the context of a Muslim society is Shariah compliance. The contract underlying a savings product must be free from elements of *riba* and *gharar*. Various contractual options for designing savings products are: *wadia*, *qard hasan* and *mudaraba*.

Wadia is an Islamic deposit. Under this mechanism, the deposits are held as *amana* or in trust and utilized by the microfinance institution at its own risk. The depositor does not share in the risk or return in any form. Any profit or loss resulting from the investment of these funds accrues entirely to the microfinance institution. Another feature of such deposits is the absence of any condition with regard to deposits and withdrawals. The term "*wadia* account" or "trust account" is used for such deposits. These are variously known as "sight deposits" or current accounts (*giro wadiah* in Indonesian institutions). Another view is to treat these deposits as *qard hasan* or benevolent loan by the depositor. As in above, the microfinance institution is free to utilize these funds at its own risk. The depositor in its role as the lender is not entitled to any return as the latter would constitute *riba*. In fact, any kind of benefit passed on to the depositor that is a part of the agreement, is deemed to be *riba*. Notwithstanding the absence of returns, such deposits form the basis of Iranian *Qard Hasan* Funds as has been discussed earlier.

It may be noted here that Islamic micro-savings products modeled after the contracts of *wadia* and *qard* do not allow any excess over and above the principal either as a stipulation in the contract or even as a unilateral gift by the microfinance institution that is not customary. If Islamic microfinance institution routinely announce a return as a "gift" for the account holder or offer other advantages in the form of services for attracting deposits, this would clearly permit entry of *riba* through the back door.

An alternative model is based on the mechanism of *mudaraba*. The microfinance institution now requires the depositors to authorize it (or appoint it as *mudarib*) for the purpose of investing the funds. Profits on investments if

positive, are shared between depositor and microfinance institution as per a pre-agreed ratio. Profits if negative, are absorbed by depositor; effectively bringing down the value of the asset created with its investments and the value of the deposit. Under this mechanism, depositors have the right of withdrawal. Profits are calculated on the basis of the minimum balance maintained for a time period (say, a month). The minimum balance maintained is deemed as the investment for that time period. A minimum balance is required to be maintained in order to qualify for a share in profits.

Mudaraba-based savings products involve considerable downside risk. Therefore, these are rarely offered by Islamic microfinance institutions. A variant of this product that takes care of the downside risk but retains upside potential is based on the notion of revenue-sharing as distinct from profit-sharing. The depositor is now completely indifferent to whether the microfinance institution is incurring high or low costs. Such products are reasonably commonplace in case of Indonesia microfinance institutions (see Box 4.1).

It should be noted here that when the savings products are remunerated on the basis of revenue-sharing rather than profit-sharing, the underlying Shariah mechanism is no longer the classical *mudaraba* but perhaps resembles the classical *wakala* or *joala* contract under which the depositor appoints the microfinance institution to manage its funds and considerable flexibility remains in the matter of prescribing the method and quantum of reward for the microfinance institution.

4.2. Micro-Credit

The Islamic alternative to interest-based conventional loan is trade-based or lease-based credit that permit the ownership and/or use of commodities or physical assets needed for productive enterprise while deferring the payments to future time periods. There are several such products developed by mainstream Islamic financial institutions involving *murabaha*, *bai-muajjal*, *ijara*, *bai-salam*, *bai-istisna*, *bai-istijrar* etc. For a detailed discussion on these modes, readers may refer to the accompanying text *Introduction to Islamic Finance*. In this section we would present a brief analysis of these modes in the context of microfinance.

Box 4.1. Islamic Micro-Savings Products in Indonesia

In Indonesian rural and microfinance, the Islamic rural banks called BPRS and Islamic savings and loan cooperatives called BMT play a significant role. In a recent study undertaken for GTZ, Prof Hans Seibel reports several examples of Islamic micro-savings products.

BPRS Artha Fisabilillah offers three *mudaraba* savings products, all voluntary and withdrawable at any time, which differ only by target group, one remuneration-free savings product for religious purposes and a fixed deposit product with different maturities. Its loan officers offer doorstep collection services, serving about 200 clients a day. Returns are calculated on a monthly basis. Annual averages vary from 7 percent to 12 percent; the unweighted mean is 8.3%. The revenue-sharing arrangements in the case of time deposits vary between the banks from 40:60 to 70:30. They also vary by maturity.

Current accounts are usually remuneration-free. An exception is BPRS Harum Hikmahnugraha, which pays a voluntary bonus. Some banks, like BPRS Artha Fisabilillah offer a savings product for religious purposes which carries no remuneration.

Deposit products of BMTs are mainly based on *mudaraba*, i.e, revenue-sharing arrangements between clients and BMT. They vary in the case of savings accounts - from 25:75 to 40:60 - averaging 34:66. In the case of time deposits, depending on maturity, from 35:65 to 45:55, averaging 42:58. Average returns p.a. are approximately 8.8 percent in the case of savings and 13.6 percent in the case of time deposits. Two of the four sampled BMTs offer current accounts, which are not remunerated.

Source: Hans Dieter Seibel, *Islamic Microfinance in Indonesia*, Sector Project Financial Systems Development Report, Deutsche Gesellschaft für Technische Zusammenarbeit (GTZ) GmbH, 2005

4.2.1. *Bai Muajjal - Murabaha*

Bai muajjal is a sale where payment of price is deferred to a future date. Often it includes features of a *murabaha*, which implies a sale on a cost-plus basis. As a micro-credit product, *bai muajjal-murabaha* is a very popular, and perhaps the most popular product among Islamic microfinance institutions (IsMFI). The mechanism may be described as follows. Individual A is in need of commodity X. He approaches IsMFI. Now, IsMFI buys X from the vendor/ supplier at price P. This price is also known to A. Next, IsMFI sells X to A at a marked-up price, say P+M, where M is the agreed profit or mark-up taken by IsMFI. The payment of price P+M is now deferred to a future date and is made in full or in parts. Note here that *bai muajjal* simply implies deferment of

payment of price irrespective of whether the cost and mark-up are known to parties or not. In a *murabaha*, both parties to the transaction must know the cost and the profit or mark-up. Where the seller does not disclose the cost and profit thereon, the transaction is called *musawama*.

A requirement of a valid sale is knowledge and specification of price and payment terms. Hence, in *bai muajjal* financing the price of the underlying commodity must be fixed at the time of contracting, as must the exact terms of payment, e.g. frequency and quantum of installment payments. This is to avoid any *gharar* or uncertainty as a source of potential conflict between the parties. This makes *bai muajjal* easy to comprehend on the part of the micro-entrepreneurs and easy to implement by the IsMFI. In *bai muajjal* a well-defined contract exists, with pre-defined amounts. Unlike profit-sharing mechanisms, *bai muajjal* does not require the client to maintain written records that are often unavailable at the micro enterprise level or if available, the client may be unwilling to share them. There is also no opportunity for abuse on the part of the client through inaccurate or false record-keeping.

Some major Shariah-related requirements if unfulfilled could make the product unacceptable in Islam. These are also the requirements that are often compromised by microfinance managers not fully conversant with Shariah. The first and foremost requirement is that the IsMFI must bear a certain amount of risk associated with ownership, such as, price risk, risk of destruction of asset etc. in order to legitimize its returns. Note that conventional IsMFI providing *riba*-based loans are also exposed to a kind of risk - the risk of default and delinquency. However, such risk exposure is not enough to legitimize gains. It is important that the subject of sale must exist in the ownership, physical or constructive possession of the seller at the time of sale. The IsMFI must have the ownership and possession of the commodity before it can sell the same to its client. Possession may be physical or constructive. The latter means a situation where the IsMFI has not taken the physical delivery of the commodity, yet it is in control of the commodity with all the rights, liabilities and risks, including the risk of destruction. In modern day trade and commerce, physical possession may not matter in the presence of adequate documentation showing ownership and constructive possession. This risk bearing by the IsMFI even if for a short or fleeting time period legitimizes IsMFI's profits in the eyes of Shariah as distinct from prohibited *riba.*

Box 4.2. *Bai Muajjal* Based Microfinance by Islamic Bank Bangladesh

The Rural Development Scheme of the Islami Bank Bangladesh has used a very successful model of attacking poverty – the Grameen model. RDS uses *bai muajjal* - where the bank is supposed to purchase the commodity required by its client from the vendor and resell the same to the client at a profit - as the Shariah-compliant mode of financing. Its use of *bai muajjal* has thrown up some serious limitations of the mechanism in the context of microfinance. *Bai muajjal* financing provided by RDS invariably involves a uniform amount (like the basic loan of Grameen). One would expect the amount of financing to vary given the wide range of commodities financed having varying prices. The commodities are not perfectly divisible either. For example, neither the price of a cow and a goat are same, nor can one buy, say, one and half goats for a pre-determined amount of funding.

Further, *bai muajjal* is not suitable for financing all kinds of income-generating activities. For example, many of RDS clients need financing for growing vegetables, fishing and other agri-based activities. Theoretically, *bai muajjal* can be used to finance the purchase of saplings, fertilizer, fishing nets and so on. In practice, however, the client would need funding not just for the physical asset(s) involved, but for the complete project and cannot be expected to approach some other agency to finance the working capital component. This is a possibility in mainstream finance, but not in microfinance with few options for the poor client. The result is not very unpredictable. RDS clients often receive funding the same way as clients of Grameen – in cash to be repaid in cash. Another major problem confronting RDS relates to span of management and supervision. It is practically impossible for a Supervisor to continuously monitor purchases and sales relating to *bai muajjal* for 400 plus clients (common to similar conventional microfinance programs) on a daily basis. Arguably, monitoring costs even for the simple conventional microloans is quite high. These would be far higher for *bai muajjal* financing if proper monitoring of end-use including Shariah compliance is undertaken.

The asset-backing nature of *bai muajjal* ensures proper monitoring of end-use and flow of funds into productive assets. However, the argument loses its strength in the context of the poor and the destitute whose immediate basic needs remain unfulfilled. It is perhaps not a sensible idea to finance an income-generating asset through *bai muajjal* for a hungry man without finding a way to meet his immediate need – food for him and his family. What he needs is cash in addition to a productive equipment.

Source: M Obaidullah (2008), *Role of Microfinance in Poverty Alleviation: Lessons from Experiences from Selected IsDB Member Countries*, IRTI, Islamic Development Bank, Jeddah, Saudi Arabia

However, when the *bai muajjal* is executed in actual practice involving recurrent and copious transactions on a day-to-day basis, the separation between the two transactions – purchase by ISMFI from vendor and sale to client - in

each *bai muajjal* financing seems to get blurred to an extent that the end result is often a cash-for-cash transaction. While the checks and balances in terms of adequate documentation showing ownership and constructive possession are relatively easy to put in place in case of mainstream IFIs (where financing involves large amounts and transactions are fewer in number), the same is extremely difficult in the context of microfinance. Microfinance by definition, involves small amounts in large frequencies. The informal setting of rural markets and businesses do not make documentation any easier. This is highlighted in an interesting case study of the Rural Development Scheme of the Islami Bank Bangladesh Limited. (see Box 4.2)

4.2.2. Micro-Leasing (*Ijara*)

Ijara in simple terms implies leasing or hiring of a physical asset. It is a popular debt-based product in which the IsMFI assumes the role of a *lessor* and allows its client to use a particular asset that it owns. The client or (lessee) is in need of the asset. Through *ijara*, it receives the benefits associated with ownership of the asset against payment of predetermined rentals. *Ijara* is for a known time period.

In *ijara,* the IsMFI continues to be the owner throughout the *ijara* period while the client receives the benefits of using the asset. As such, risks associated with ownership of the asset remain with the IsMFI and the asset is supposed to revert back to the IsMFI at the end of the *ijara* period. The cash flows are structured in a way that cover the cost of the asset and provide for a fair return on the same to the IsMFI. The IsMFI after recovering its cost and fair return may simply donate the asset or sell the asset at a nominal price to its client. Micro-leasing or micro-*ijara* serves as a mode of microfinance. All kinds of income-generating equipment or physical asset, such as, tools and machines to manufacture commodities, rickshaws and boats to transport people, carts as also shops to sell merchandize, low-cost houses may be financed through this mode for the poor.

An important Shariah rule governing *ijara* as a tool of microfinance is that the risk and liabilities emerging from the ownership of the asset substantially remain with the *lessor* - IsMFI in order that its profits are deemed legitimate in the eyes of Shariah. In a conventional financial lease, the *lessor* transfers substantially the risks and rewards incidental to the ownership of the leased assets to the lessee even while the title of the leased asset may or may not eventually be transferred to the lessee. The complete transfer of risk makes the finance lease unacceptable from the Shariah point of view.

In Islamic leasing or *ijara*, the leased asset remains as *amana* or in trust with the lessee. There is no compensation in *amana* in case of destruction of asset value, except when the loss is caused due to the negligence of the lessee. Thus, the leased asset remains in the risk of the *lessor* throughout the *ijara* period, in the sense that any loss, damage or loss caused by the factors beyond the control of the lessee shall be borne by the *lessor*. In this sense, Islamic *ijara* is different from conventional leasing. Agreements of conventional financial lease generally do not differentiate between the two situations. In an Islamic *ijara*, both situations are to be dealt with separately.

A *lessor* can, of course, mitigate his risk by making the lessee specifically liable for damages, theft and/or loss on destruction of assets except in the case of force majeure. Further, specific risks of the *lessor* relating to the physical damage, theft and/or loss on destruction of the leased asset may be covered by Islamic insurance or *takaful*. The *lessor*- IsMFI may include the cost of *takaful* premium in the *ijara* rental. Any escalation in the *takaful* premium may also trigger rent adjustment if it is specified in the *ijara*.

4.2.3. Other Modes of Extending Credit

Besides the above there are several other interesting modes of extending credit that have been developed and are in use in mainstream Islamic finance. We briefly present them below.

Bai-Salam:

Bai-salam is a deferred delivery contract. It is essentially a forward agreement where delivery occurs at a future date in exchange for spot payment of price. Unlike earlier mechanisms of *murabaha* and *ijara*, *salam* or *salaf* was originally designed as a financing mechanism for small farmers and traders. Under a *salam* agreement, a farmer or a trader in need of short-term funds sells its output or merchandize to the IsMFI on a deferred delivery basis. It receives full price of the merchandize on the spot that serves its financing need at present. At a pre-agreed future date, it delivers the merchandize to the IsMFI. The IsMFI sells the merchandize in the market at the prevailing price. Since the spot price that the IsMFI pays is pegged lower than the expected future price, the transaction should result in a profit for the IsMFI. In practice, the IsMFI could be an association of the farmers or artisans or traders or an agency to undertake collective marketing of the members' produce.

Bai-Istisna:

Bai-Istisna is a contract of manufacture. A seller under an *istisna* agreement undertakes to develop or manufacture a commodity with clear specifications for an agreed price and deliver after an agreed period of time. The unique feature of *istisna* is that nothing is exchanged on spot or at the time of contracting. The buyer makes payment of price in parts over the agreed time period or in full at the end of the time period. In an *istisna*, the seller and the manufacturer may be different entities. This allows an IsMFI to engage in *istisna* by assigning the job of development, manufacture or construction to a third party under a parallel *istisna* arrangement.

Bai-Istijrar:

Bai-Istijrar takes place when the buyer purchases different quantities of a given commodity from a single seller over a period of time. In other words, the seller delivers the total quantity of commodity purchased in installments. Since *istijrar* involves repeat purchases from a single seller, some scholars see a room for flexibility in the matter of fixation and payment of price. According to this view, the payment of price may be deferred to a future date and may indeed be based on a normal price or average price prevailing in the market. This mode is ideal for microfinance where micro-entrepreneurs often buy their raw materials and inputs in small quantities from the same vendor over extended periods.

All the above modes create debt and may be used by an IsMFI as Islamic modes of extending micro-credit. A major problem associated with such modes relates to the possibility of willful default by clients. Unlike conventional microfinance where defaults may result in additional interest payments and/or rescheduling of loan and prepayment may result in rebates, Islamic modes do not admit the possibility of any payment in excess of the original amount of debt. Islamic scholars generally permit the IsMFI to impose a penalty on the defaulting client to act as a deterrent against willful default, but such penalty must be donated to a charity. It cannot be treated as an earned income for the IsMFI as this would tantamount to *riba*.

4.3. Micro-Equity

IsMFI may consider various partnership based modes or equity based modes for microfinance. Two classical modes commonly discussed in this context are *mudaraba* and *musharaka*. The former involves a combination of entrepreneurship and capital while the latter involves a partnership in

entrepreneurship and capital. We also discuss a novel concept of declining *musharaka* leading to complete ownership of asset or project by the micro-entrepreneur. These equity-based products are unique to Islamic microfinance and in some sense, account for its superiority over conventional microfinance on grounds of ethics and efficiency. Arguably, because of their uniqueness, they are also less popular.

A *mudaraba* also known as trustee-partnership is a mode of microfinance through which the IsMFI provides capital finance for a specific venture indicated by the micro-entrepreneur. The IsMFI, called *rabb-al-mal* is the owner of the capital and the micro-entrepreneur, called *mudarib*, is responsible for the management of the business and provides professional, managerial and technical expertise for initiating and operating the business enterprise or project. Profit is shared according to a pre-agreed ratio. Losses if any, are entirely absorbed by the capital provider – the IsMFI. *Mudaraba* may be of two types – restricted or unrestricted. In a restricted *mudaraba* (*mudaraba* al-*muqayyada*) the IsMFI may specify a particular business in which investments may be undertaken. *Mudaraba* may also be an unrestricted one (*mudaraba al-mutlaqa*); in which case the *mudarib* may invest the capital provided in any business he deems fit.

A *musharaka* or a joint venture involves a partnership in which both the IsMFI and its micro-entrepreneur contribute to entrepreneurship and capital. It is an agreement whereby the micro-entrepreneur and the IsMFI agree to combine financial resources to undertake any type of business venture, and agree to manage the same according to the terms of the agreement. Profits are shared between the IsMFI and the micro-entrepreneur in the pre-agreed ratio. Losses are shared strictly in proportion to their respective capital contributions.

A variant of the above called diminishing *musharaka* has great potential for the IsMFI as a microfinance product. While a classical *musharaka* aims to involve the IsMFI as a permanent partner in the venture, in a declining *musharaka*, the IsMFI's share in the equity is diminished each year through partial return of capital. The IsMFI receives periodic profits based on its reduced equity share that remains invested during the period. The share of the client in the capital steadily increases over time, ultimately resulting in complete ownership of the venture.

Islamic for-profit microfinance in spite of the richness of *fiqh* literature remains highly *murabaha*-centric. Even *ijara* has not witnessed many takers among IsMFIs unlike the mainstream Islamic FIs. Profit-loss-sharing, though highly acclaimed as “ideal” is hardly used (with a few exceptions, such as, in

Indonesia). Agency problem with Profit-Loss-Sharing (PLS) in mainstream Islamic finance is cited as the key reason behind preference of Islamic FIs for debt-based products. They become particularly acute in rural settings. Other problems that are usually cited with PLS-based modes as compared to sale and lease based modes are as follows: One, PLS mechanisms require long-term involvement by the microfinance institutions in the form of technical/ business assistance which raises the cost of implementation. Two, the uncertainty about profits is a major drawback of the PLS models. Although microfinance programs have information on local market behavior, weekly profits fluctuate. Fluctuating profits make it extremely difficult for institutions to predict their cash flows. Micro-entrepreneurs make the job doubly difficult by not keeping accurate accounts. Three, the PLS model is difficult to understand for loan officers and borrowers alike. Even in the hypothetical situation that profits were known, the borrower has to repay a different amount each period (and the loan officer has to collect a different amount each period). This lack of simplicity—relative to equal repayment installments—is a source of confusion for borrowers and loan officers.

4.4. Other Services

As indicated earlier, the poor also need many other services besides savings and financing, such as, remittance. These services may be easily provided by an IsMFI in a fee (*ujrat*) based framework. In order that these services are provided in a *riba*-free manner, scholars insist that the quantum of fee is delinked from the quantum of funds involved and is based on the costs incurred in the process of offering the services.

4.5. A Composite Model of Islamic Microfinance

Earlier, we have discussed a model of microfinance based on Islamic non-profit modes. We now combine them with for-profit modes and present a composite model of Islamic microfinance. The model is presented in Figure 2 below. The model may be described in terms of activities 1-11 as follows:

1. Islamic Microfinance Institution (IsMFI) or Program creates a *Zakah* Fund with contribution from *muzakki*;
2. Program facilitates *Waqf* of physical assets as well as monetary assets. The physical assets are used to facilitate education and skills training. The monetary assets may be in the form of a cash *waqf*, or simply as ordinary *sadaqa*;

3. Program carefully identifies the poorest of the poor and the destitute who are economically inactive and directs a part of *zakah* funds towards meeting their basic necessities as grant, seeks to provide a safety net;

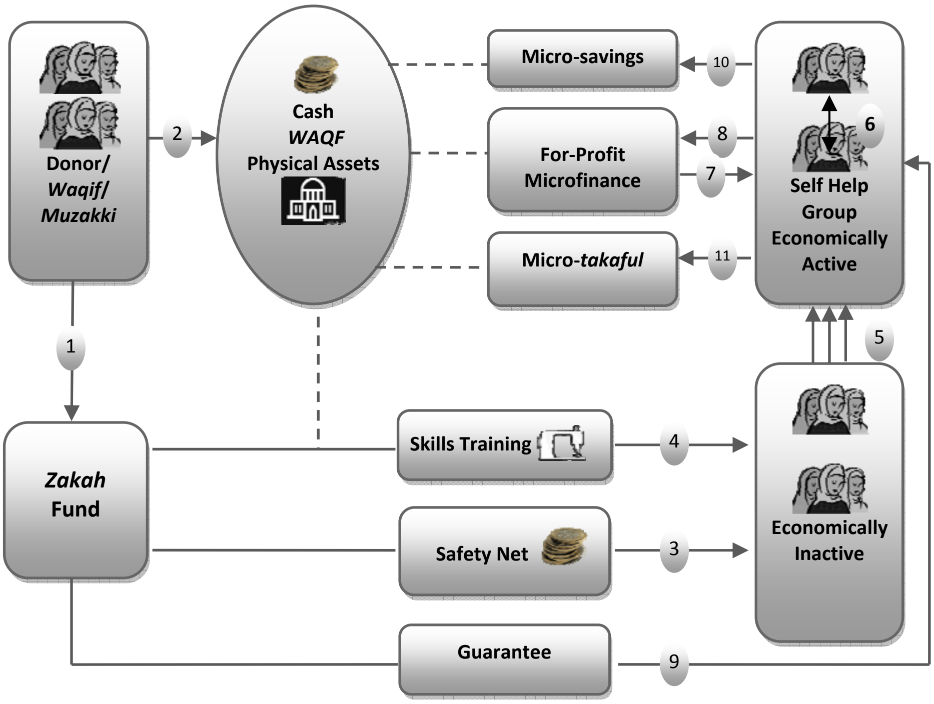


Figure 2: Composite Model of Islamic Microfinance

4. Program provides skills training to economically inactive, utilizing community-held physical assets under *waqf*;
5. Beneficiaries graduate with improved skills and managerial acumen;
6. Beneficiaries are formed into groups with mutual guarantee under the concept of *kafala*;
7. Financing is provided using a combination of for-profit debt-based modes, such as, *bai-muajjal*, *ijara*, *salam*, *istisna* or *isijrar* or equity-based modes, such as, *mudaraba* or *musharaka* or declining *musharaka*;
8. Group members pay back their debt; and/or perform and meet the expectations of equity providers and, in turn, are provided higher levels of financing;
9. Guarantee against default by the group is provided by the *Zakah* Fund and actual defaulting accounts are paid off with *zakah* funds;

10. Group members are encouraged to save under appropriate micro-savings schemes;
11. Groups members are encouraged to form a *Takaful* Fund to provide micro-insurance against unforeseen risks and uncertainties resulting in loss of livelihood, sickness and so on;

4.6. Islamic Microfinance Programs across the Globe[10]

Cases of successful Islamic microfinance experiments in Muslim societies are small in number. Further, these institutions are not integrated into the formal financial systems, with the notable exception of Indonesia. In most cases these are in the nature of experimental projects initiated by international donor agencies, religious or political groups. Cases of Islamic banks practicing microfinance are even fewer. Islamic microfinance institutions display wide variations in the models, instruments and operational mechanisms. While, in terms of reach, penetration and financial prowess, Islamic microfinance institutions lag far behind their conventional counterparts they certainly score better in terms of richness and variety. Islamic microfinance institutions similar to conventional microfinance institutions, use group financing as a substitute to collateral, have a high concentration of women beneficiaries and aim at alleviation of poverty in all its forms.

4.6.1. Middle East North Africa (MENA)

It was a microfinance initiative in Egypt - the Mit Ghamr project that laid the foundation of modern Islamic banking, notwithstanding the short lifespan of the project. In the Middle East North Africa (MENA) region several successful experiments have been undertaken recently: (i) the Sanadiq project at Jabal al-Hoss in Syria; (ii) the Mu'assasat Bayt Al-Mal in Lebanon; and the (iii) Hodeidah Microfinance Program in Yemen.

4.6.1.1. The Jabal Al Hoss "Sanadiq" (village-banks) in Syria is an excellent model worth replication. Some of the unique features of this model are: (i) *musharaka*-type structure owned and managed by the poor; (ii) financing based on the concept of *murabaha* – high profit rates with net profits shared among members; (iii) good governance through committees with sound election and voting procedures; (iv) project management team responsible for creating awareness of microfinance practices, training of committee members; (v) financial management of the funds based on standardized by-laws and statutes

[10] This section draws heavily on *Framework for Developing Islamic Microfinance Services,* Policy Paper, IRTI, Islamic Development Bank, Jeddah, Saudi Arabia

for each of the village funds resulting in “fair” credit decisions and low transaction costs. (vi) financially viable operations with repayment rates close to cent percent (vii) equal access to both men and women as owners and users; (viii) Sanadiq Apex Fund for liquidity exchange and refinancing; and (ix) support from UNDP in the form of matching grant equal to minimum share capital of village fund.

4.6.1.2. The Mu’assasat Bayt Al-Mal in Lebanon is an affiliate of a political party – the Hezbollah and comprises the Hasan Loan Institution (*Al-Qard Al-Hasan*) and its sister organization called Al-Yusor for Finance and Investment (*Yusor lil-Istismar wal Tamweel*). The former provides *qard-hasan* financing while the latter provides financing on a profit-loss-sharing mode. The uniqueness of the Mu’assasat Bayt Al-Mal is its emphasis on voluntarism. It has maintained a very close relationship with the people and is seen as a very creditable organization with volunteers entirely taking care of collection and disbursal of funds. It has a network of donors with complete confidence in the activities of the Institution and also enjoys high repayment rate. Financing is backed by collateral in the form of capital assets, land, gold, guarantor and bank guarantee.

4.6.1.3. The Hodeidah Microfinance Program in Yemen predominantly uses group and graduated financing methodology that was successfully pioneered by Grameen. Unlike Grameen however, it uses a *murabaha* mode for financing.

4.6.2. South Asia

Among South Asian countries Bangladesh leads the group with organizations like Islami Bank Bangladesh, Social and Investment Bank, Al-Fallah and Rescue. Akhuwat in Pakistan is notable for its unique mosque-based model. India with its second largest Muslim population in the world has witnessed some experiments largely outside its formal financial system, such as, AICMEU and Bait-un-Nasr.

4.6.2.1. The Islamic microfinance institutions in Bangladesh have been primarily using deferred-payment sales (*bai muajjal*) mode of financing. They have been facing tough competition from conventional giants like Grameen Bank and BRAC. Though according to some studies, Islamic microfinance institutions have displayed better financial performance than their conventional counterparts, the latter have a far greater outreach. Indeed, institutions like Grameen and BRAC have pioneered models of microfinance that are replicated across the globe.

4.6.2.2. In Pakistan a model of micro-financing that has generated considerable interest among observers is Akhuwat. The financing is in the nature of small interest free loans (*qard hasan*) in a spirit of Islamic brotherhood where most activities are performed by volunteers. There is no funding from international donors or financial institutions. All activities revolve around the mosques and involve close interaction with the community. There are no independent offices; loans are disbursed and recovered in mosque and therefore involve low overheads. It uses collateral-free group and individual financing based on mutual guarantees. Loans are disbursed in a mosque, which also attaches a religious sanctity to the oath of returning it on time.

4.6.3. South East Asia

In South East Asia Malaysia made an early beginning with Tabung Haji aimed at financing the Hajj related expenditure of poor Malaysian farmers who used to sell their only source of livelihood, agricultural land, for the purpose. Tabung Haji was primarily a savings-and-investments-institution and has since grown into a large specialized finance house. Indonesia has largely followed Malaysia in the development of the Islamic financial sector including the microfinance sector. Cases of Islamic microfinance projects have also been documented for Thailand, Brunei and Philippines.

4.6.3.1. With its rather developed Islamic banking system and capital markets, Malaysia has established several organizations under the aegis of government agencies to finance small and medium scale enterprises using a wide range of Islamic financial instruments.

4.6.3.2. Islamic microfinance institutions in Indonesia may be placed in three categories- the microfinance divisions of Islamic banks, the Islamic rural banks (BPRS) a subcategory of the rural banks (BPR); and the Islamic financial cooperatives that are not part of the formal financial sector. They are generally referred to as *Baitul Maal wat Tamwil* (BMT). At the grassroots level, the *Baitul Maal wat Tamweels* (BMTs) are a large network of over two thousand institutions serving millions of poor Indonesian Muslims. These BMTs are floated by a wide variety of organizations including Islamic banks, BPRS and are at times backed by Islamic organizations, such as, Nahdatul Ulama and Muhamadiyah that currently have over hundred million members. *Zakah* funds are also an integral part of the BMTs. Unlike many single-product (*murabaha* or *qard-hasan* based) Islamic microfinance programs and projects in other regions, the financing portfolios of Indonesian IsMFIs are reasonably balanced with an

array of products – based on *mudaraba, musharaka, murabaha, ijara* and *qard-hasan*.

Islamic microfinance institutions (IsMFIs) in Indonesia have displayed their sustainability and robustness in the face of grave financial crises even when the mainstream banks had to depend on governmental assistance to tide over serious financial problems. It should be noted that Indonesian BMTs at the grassroots largely fall outside the financial regulatory mechanism since they operate as member-based cooperative organizations (similar to a *musharaka structure*) without governmental assistance or intervention. These organizations have been found to be less vulnerable to systemic risks that arise due to interdependence, as each BMT is an independently operating entity. As such, the system poses a serious challenge to the regulator – how to strike a balance between the need to strengthen the linkage between formal financial system and the BMTs while retaining the benefits of flexibility and independence.

4.6.4. Sub-Saharan Africa

In Sub-Saharan Africa the only Islamic microfinance program that has been documented well operates in Northern Mali. It was borne out of a development project by the GTZ (German Technical Cooperation) and KfW (German Financial Cooperation) in the former civil war areas of Timbuctu', Mali. The aim of the project, inter alia, was to provide financial services to all the tribes of the area, the Moors, the Tuareg and various black African groups. It was felt that a bank that would be acceptable to all previous civil war opponents had to be an Islamic one and this led to establishment of the Azaouad Finances plc. The bank operates primarily on a PLS basis, is linked with the SWIFT international payments system, thus giving a fillip to local trade and commerce in a big way.

4.6.5. Central Asia

Out of the countries with large Muslim populations in Central Asia - Afghanistan, Azerbaijan, Kazakhstan, Tajikistan, Uzbekistan, Kyrghizstan only the former two have witnessed experiments in Islamic microfinance.

4.6.5.1. The only Islamic microfinance program being run in Afghanistan is by FINCA. The program involves *qard-hasan* with service charge that is not related to amount of financing as a percentage and that is charged upfront as a fee. FINCA's Village Banking methodology targets the working poor with its "solidarity" group guaranteed loans.

Glossary of Arabic Terms

Word	**Definition**
Akhuwat	Brotherhood.
Al-rahn	Collateral
Awqaf	Plural of *waqf*. For meaning, see below.
Bait-ul-Maal	Public treasury, Also used for a charitable institution meant to help the poor and needy.
Bai muajjal	Sale on credit, i.e. a sale in which goods are delivered immediately but payment is deferred.
Bai salam	A sale in which payment is made in advance by the buyer and the delivery of the goods is deferred by the seller.
Bai-bithaman-ajil	Another term used for *bai muajjal.*
Bai-istijrar	Recurring sale or purchase
Damana	Guarantee, security.
Darar	Damage, harm, injury.
Fiqhi	Refers to the whole corpus of Islamic jurisprudence. In contrast with conventional law, *fiqh* covers all aspects of life, religious, political, social, commercial or economic. The whole corpus of *fiqh* is based primarily on interpretations of the Qur'an and the *sunnah* and secondarily on *ijma* (consensus) and *ijtihad* (individual judgement). While the Qur'an and the *sunnah* are immutable, *fiqhi* verdicts may change due to changing circumstances.
Gharar	Literally, it means deception, danger, risk and uncertainty. Technically it means exposing oneself to excessive risk and danger in a business transaction as a result of uncertainty about the price, the quality and the quantity of the counter-value, the date of delivery, the ability of either the buyer or the seller to fulfil his commitment, or ambiguity in the terms of the deal; thereby, exposing either of the two parties to unnecessary risks.
Hadith	Sayings, deeds and endorsements of the Prophet Muhammad (peace be upon him) narrated by his Companions.
Halal	Things or activities permitted by the Shariah.
Heba	Gift.
Ijara	Leasing. Sale of usufruct of an asset. The lessor retains the ownership of the asset with all the rights and the responsibilities that go with ownership.

Istijrar	Same as *Bai-Istijrar*
Istisna	Refers to a contract whereby a manufacturer (contractor) agrees to produce (build) and deliver a well-described good (or premise) at a given price on a given date in the future. As against *salam*, in *istisna* the price need not be paid in advance. It may be paid in installments in step with the preferences of the parties or partly at the front end and the balance later on as agreed.
Jahl	Ignorance, lack of knowledge. In contracts, it refers to lack of information with respect to the subject of the contract or the terms and conditions of the contract.
Kafala	A contract whereby a person accepts to guarantee or take responsibility for a liability or duty of another person.
Mudaraba	A contract between two parties, capital owner(s) or financiers (called *rabb al-mal*) and an investment manager (called *mudarib*). Profit is distributed between the two parties in accordance with the ratio upon which they agree at the time of the contract. Financial loss is borne only by the financier(s). The entrepreneur's loss lies in not getting any reward for his services.
Mudarib	An investment manager in a *mudaraba* contract.
Murabaha	Sale at a specified profit margin. The term, however, is now used to refer to a sale agreement whereby the seller purchases the goods desired by the buyer and sells them at an agreed marked-up price, the payment being settled within an agreed time frame, either in installments or in a lump sum. The seller bears the risk for the goods until they have been delivered to the buyer. *Murabaha* is also referred to as *bay muajjal.*
Musharaka	Partnership. A *musharaka* contract is similar to a *mudaraba* contract, the difference being that in the former both the partners participate in the management and the provision of capital, and share in the profit and loss. Profits are distributed between the partners in accordance with the ratios initially set, whereas loss is distributed in proportion to each one's share in the capital.
Qard Hasan	A loan extended without interest or any other compensation from the borrower. The lender expects a reward only from God.

Quran	The Holy Book of Muslims, consisting of the revelations made by God to the Prophet Muhammad (peace be upon him). The Quran lays down the fundamentals of the Islamic faith, including beliefs and all aspects of the Islamic way of life.
Rabb al-Mal	Capital owner (financier) in a *mudaraba* contract.
Riba	Literally, it means increase or addition or growth. Technically it refers to the 'premium' that must be paid by the borrower to the lender along with the principal amount as a condition for the loan or an extension in its maturity. Interest as commonly known today is regarded by a predominant majority of *fuqaha* to be equivalent to *riba*.
Sadaqah	An act of charity.
Salam	The short form of *bai al salam*.
Shariah	Refers to the corpus of Islamic law based on Divine guidance as given by the Quran and the *sunnah* and embodies all aspects of the Islamic faith, including beliefs and practices.
Tabarru	Actions/contracts the purpose of which is not commercial but is seeking the pleasure of Allah.
Takaful	An alternative for the contemporary insurance contract. A group of persons agree to share certain risk (for example, damage by fire) by collecting a specified sum from each. In case of loss to anyone of the group, the loss is met from the collected funds.
Ujrat	Fee, remuneration
Ulama	Scholars.
Wadia	A contract whereby a person leaves valuables with someone for safekeeping. The keeper can charge a fee, even though in Islamic culture it is encouraged to provide this service free of charge or to recover only the costs of safekeeping without any profit.
Wakala	Contract of agency. In this contract, one person appoints someone else to perform a certain task on his behalf, usually against a fixed fee.
Waqf	Appropriation or tying up a property in perpetuity for specific purposes. No property rights can be exercised over the corpus. Only the usufruct is applied towards the objectives (usually charitable) of the *waqf*.

Zakah — The amount payable by a Muslim on his net worth as a part of his religious obligations, mainly for the benefit of the poor and the needy. It is an obligatory duty on every adult Muslim who owns more than a threshold wealth.

About the Author

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- Islamic Microfinance Development: Challenges and Initiatives (Principal Author), IRTI, IDB, 2008
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